S. HRG. 107–543

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2003

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

January 23, 24, 2002—THE BUDGET AND ECONOMIC OUTLOOK

January 29, 2002—THE BUDGET AND THE ECONOMY

February 5, 6, 12, 13, 14, 2002—THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSALS

February 7, 2002—THE PRESIDENT'S FISCAL YEAR 2003 BUDGET AND REVENUE PROPOSAL DEBT MANAGEMENT

February 26, 2002—THE EFFECT OF THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSALS ON THE ARMY CORPS OF ENGINEERS, THE FEDERAL HIGHWAY ADMINISTRATION, AND THE DEPARTMENT OF EDUCATION

February 27, 2002—THE LONG-TERM BUDGETARY OUTLOOK

February 28, 2002—THE PRESIDENT'S FISCAL YEAR 2003 DEFENSE REQUEST: WINNING THE WAR, TRANSFORMATION, AND REFORM ISSUES

March 6, 2002—THE CONGRESSIONAL BUDGET OFFICE'S ANALYSIS OF THE PRESIDENT'S PROPOSALS FOR FISCAL YEAR 2003

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CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2003

BUDGET AND ECONOMIC OUTLOOK

WEDNESDAY, JANUARY 23, 2002

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

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

Present: Senators Conrad, Hollings, Sarbanes, Murray, Feingold, Johnson, Byrd, Nelson, Stabenow, Clinton, Corzine, Domenici, Grassley, Gramm, Snowe, Smith, Allard, and Hagel.

Staff present: Mary Ann Naylor, staff director; and Jim Horney, deputy staff director.

For the minority: G. William Hoagland, staff director; and Cheri Reidy, senior analyst for budget review/revenues and Bob Stein, chief economist.

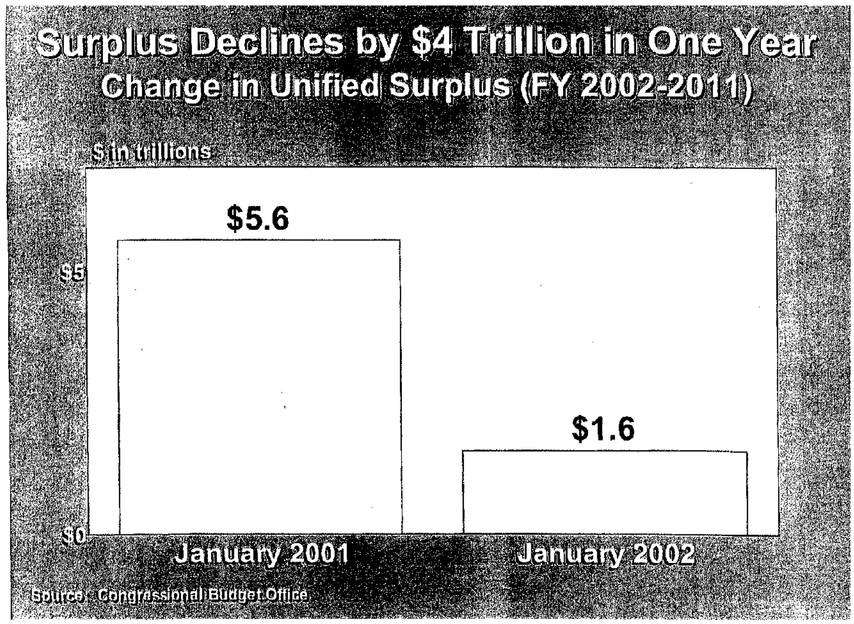
OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

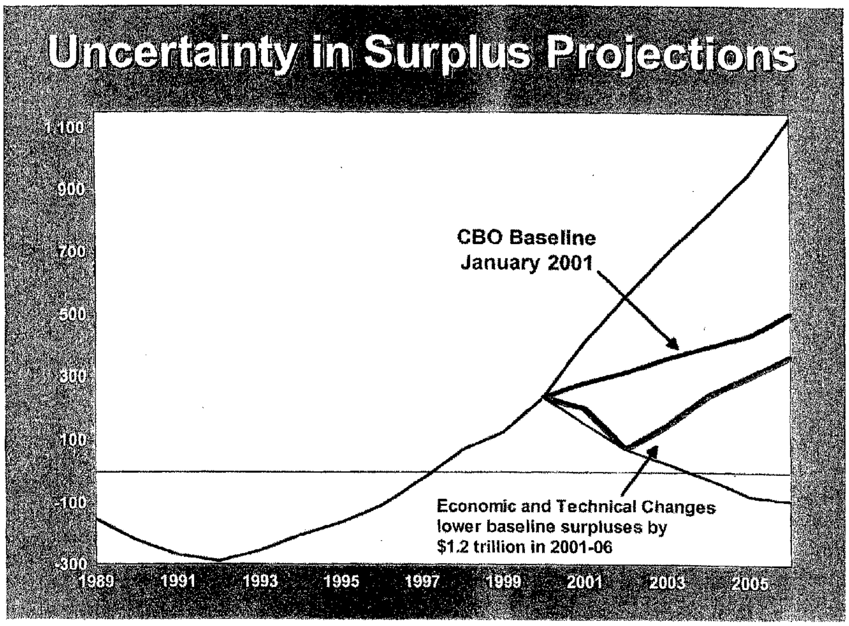
First, I want to thank Director Crippen for being here today. We certainly appreciate the extraordinary efforts that you and your staff have made given the shortness of time between when Congress left town and the need to reassess our fiscal condition. We appreciate very much the efforts that you have extended as well as your excellent staff.

As I look at the numbers, I'm reminded of the phrase "What a difference a year makes." It really is quite startling.

Last year, as we convened, we were told that we could expect surpluses of $5.6 trillion over the period of 2002 through 2011. Now we see that that has been dramatically reduced to $1.6 trillion, a $4 trillion deterioration in projected surpluses.



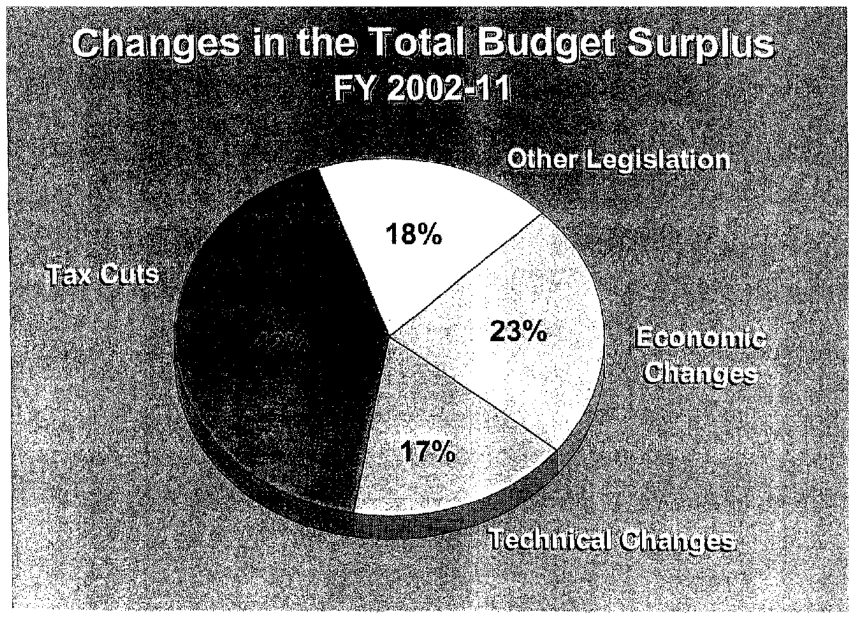
I want to be quick to point out that you warned us very clearly of the uncertainty of those forecasts. We have the fan chart that we discussed so many times last year, which you prepared, which showed the dramatic uncertainty of any 10-year forecast. And what we now see, the red line shows the new forecast in relationship to that fan forecast, which showed the range of estimates, what might happen. And what we now see is for the next several years we are actually at the bottom of the range.



There were some of my colleagues who told me that the $5.6 trillion of projected surpluses was understated. I remember many of my colleagues, some of them on this committee, who told me repeatedly, Oh, don't worry, there is going to be actually more money, that these forecasts are understated. Well, unfortunately, history has proved them wrong.

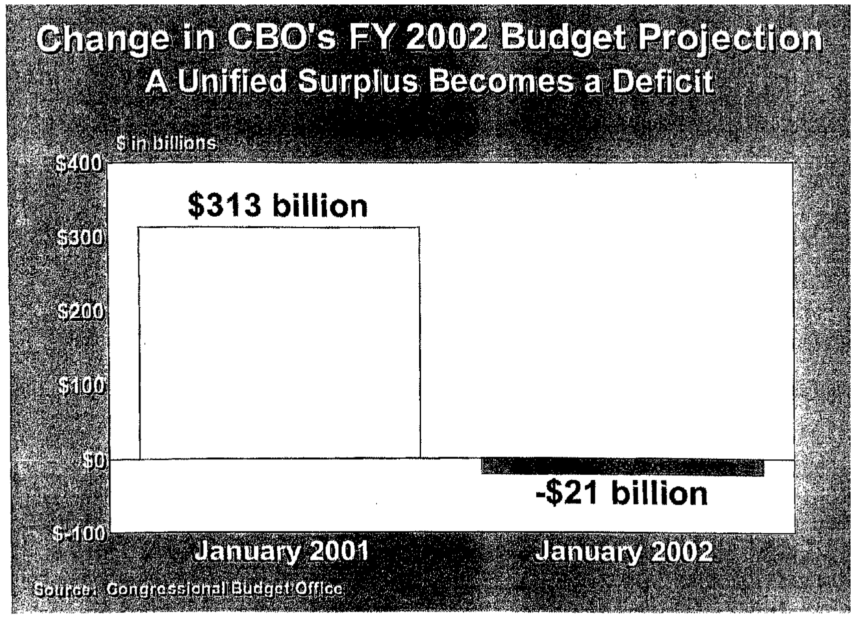
Many of us repeated the warnings that you gave us last year. I remember showing that chart of uncertainty over and over in this committee and on the floor. But, unfortunately, the President told us and told the American people that we could have it all. He told us that we could have a massive tax cut that he proposed, that we could have a big defense buildup, that we could save every penny of the Social Security and Medicare Trust Funds and still be able to pay down the maximum amount of our debt. Unfortunately, he was wrong, and he was wrong by a country mile.

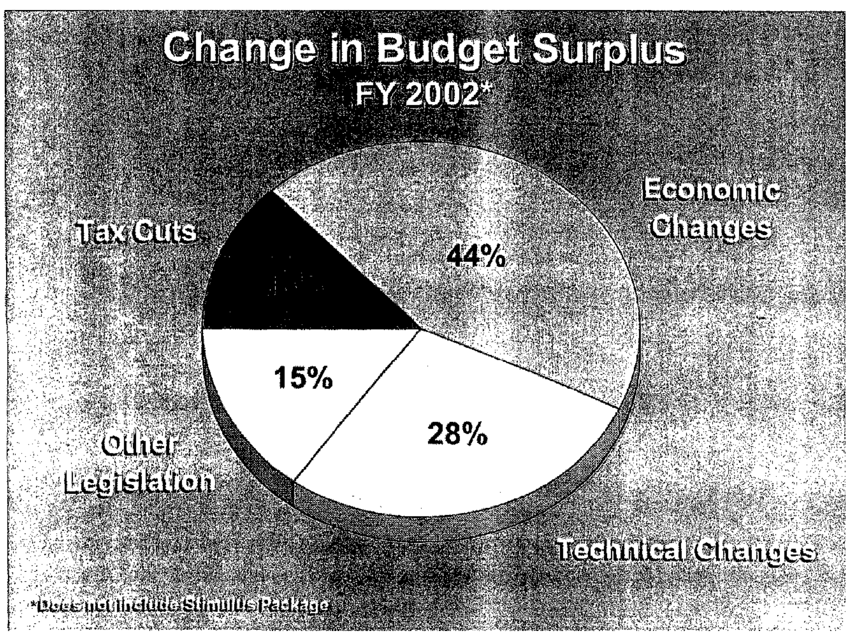
The consequences of those mistakes are enormous for the Nation. So how did it happen? Well, the biggest reason for the disappearance of the some $4 trillion of projected surpluses was the tax cut. Our analysis of your numbers shows that some 42 percent of the reduction is from the tax cut; 23 percent are economic changes; 18 percent is other legislation, largely spending as a result of the attack on September 11th; and 17 percent, technical changes.



So the biggest factor in the 10-year change is the tax cut. That is the tax cut itself, and, of course, the additional interest cost associated with the tax cut.

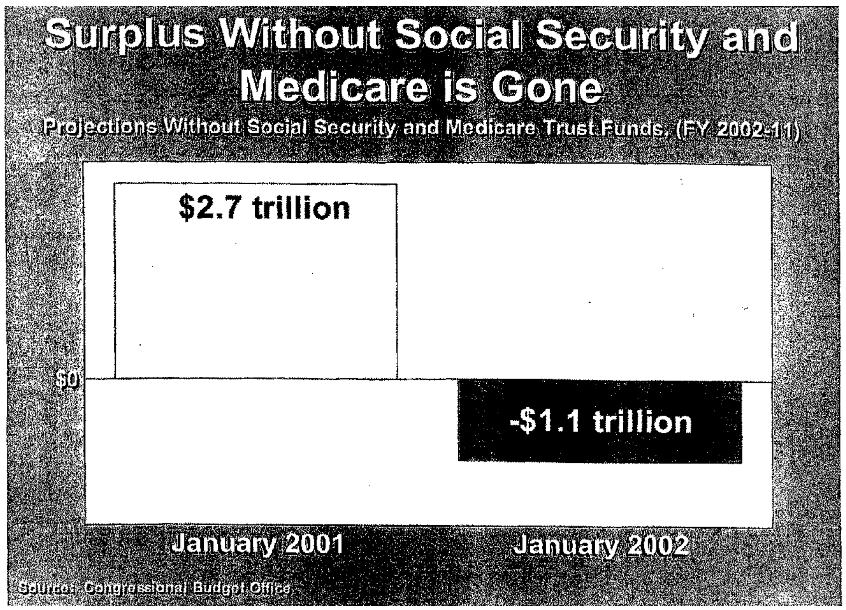
If we are to look at just this year, we see a dramatic reduction from $313 billion of projected surplus to a $21 billion deficit, a very dramatic change in our short-term circumstance. And when we look at the reasons for that reduction, it is different than the 10-year analysis. The biggest reason for the reduction this year are the economic changes. They account for 44 percent of the change; 28 percent is because of technical changes, things like capital gains realizations and growth in Medicare and Medicaid spending; other legislation, largely spending associated with the attack of September 11th, is 15 percent; and the tax cut is 13 percent.



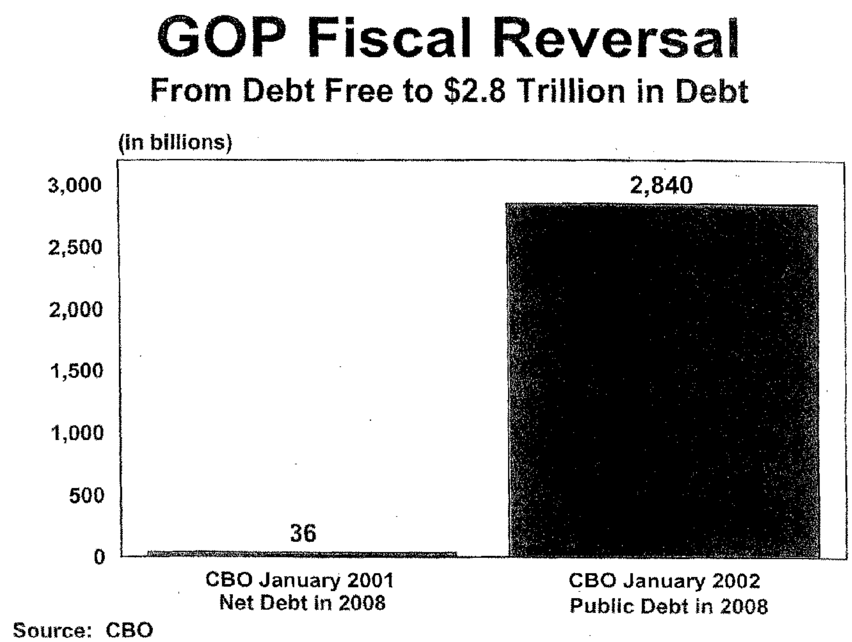


So in the short term, the recession is the biggest reason for the decline in our projected surpluses. In the long term, the biggest reason is the tax cut.

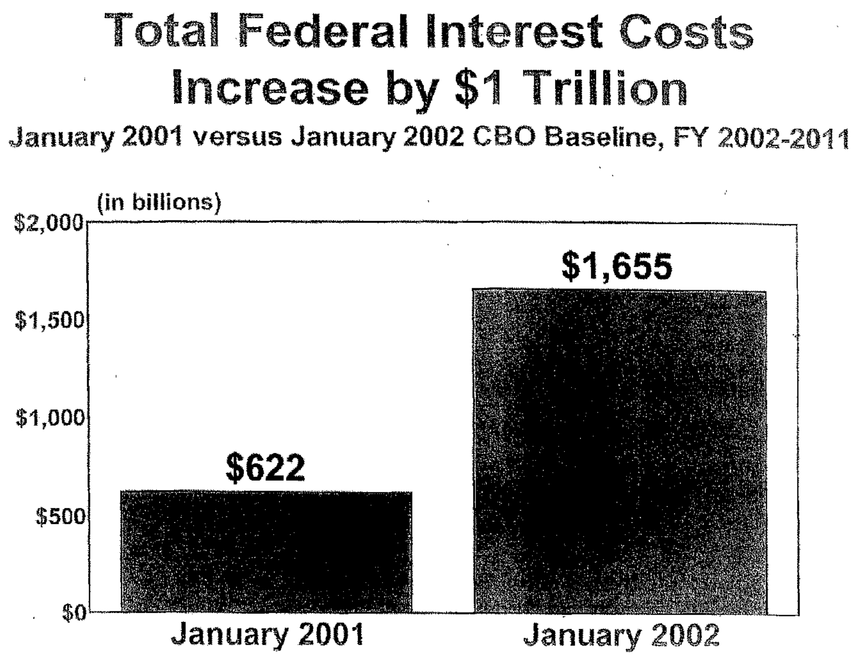
I think it is further important to understand that, without Social Security and Medicare Trust Fund moneys, the surpluses would be nonexistent. Now, this chart shows last year we were looking at, without Social Security and Medicare, $2.7 trillion of surplus. Without Social Security and Medicare, this year we would see that we would be $1.1 trillion in the hole.



The consequences of these fiscal mistakes are serious and, unfortunately, long-lasting. Last year we were told that we would be debt free in 2008. Now we see, instead of being debt free, that we will actually be $2.8 trillion in debt. And, of course, consequences flow from those changes.



The interest costs for the Federal Government increase by $1 trillion over what we were told last year. Instead of $600 billion of interest cost over the forecast period, we now see interest cost to the Federal Government of over $1.6 trillion. And despite the President's pledge, which was no doubt well intended, not to invade the Social Security Trust Fund, unfortunately we now see that the Social Security Trust Fund will be invaded by over $700 billion. And in addition to that, over $380 billion of Medicare Trust Funds will be used to pay for his tax cut and other expenses of the Federal Government.



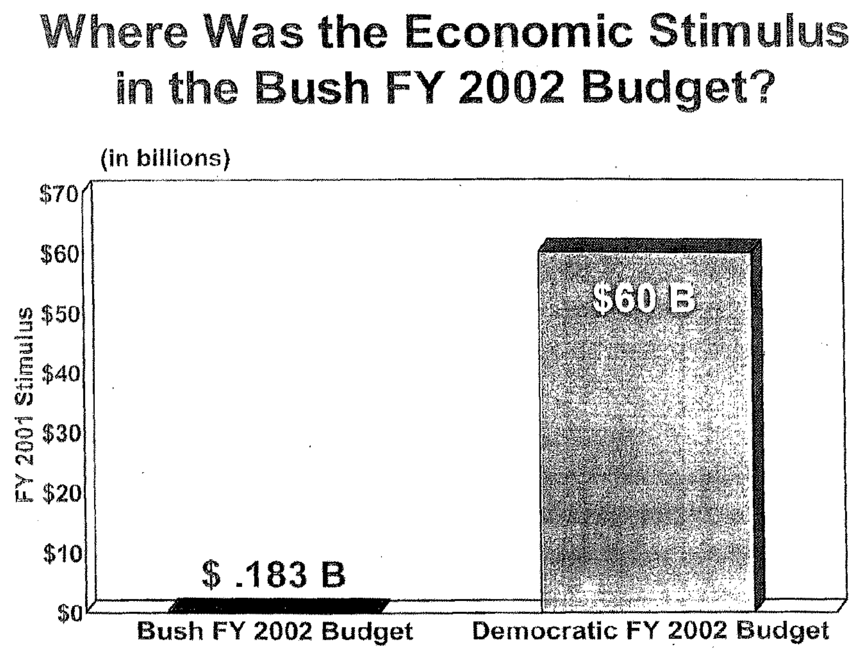
I believe that is a profound mistake when the first baby-boomers start retiring in just 2008. It seems hard to believe, but that soon the baby-boomers will start to retire, and then our fiscal challenges really begin.

So the question before us now is: What do we do? I do not believe that raising taxes at a time of economic slowdown would be wise. I believe that would only deepen the downturn.

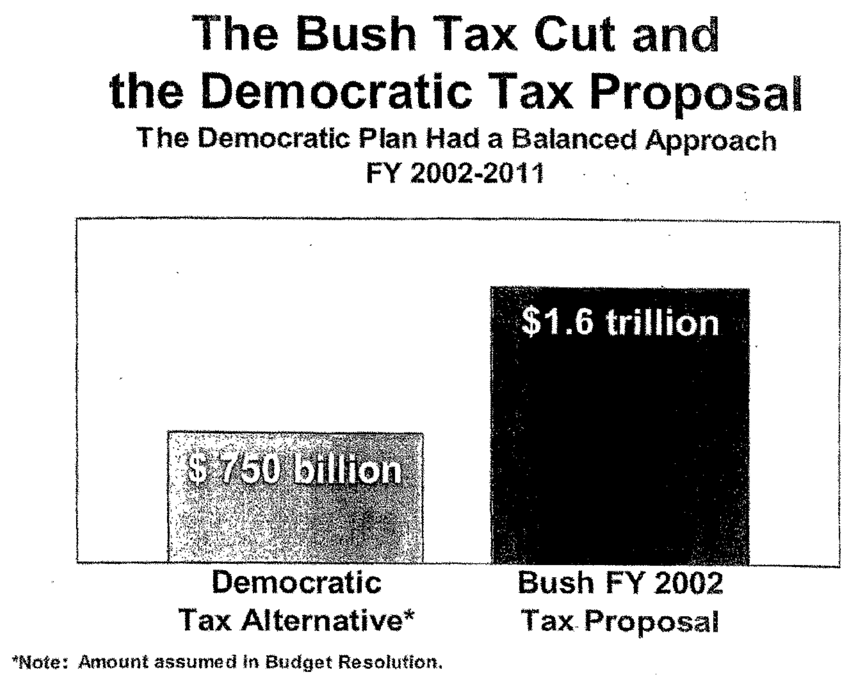
Second, I believe we should pass a stimulus package this year to give lift to the economy.

Third, for the longer term, we should restore the integrity of the trust funds of Social Security and Medicare, and we should do it as quickly as we can.

On a final note, I want to make clear that this debate about budget priorities was never a question of the President being for tax cuts and Democrats being opposed. In fact, last year we proposed in our budget plan a larger tax cut for last year than the President did in his budget proposal. We believed a tax cut of $60 billion last year was important to give lift to the economy. But we proposed substantially smaller tax reductions over the 10 years because we feared the President's proposal endangered Social Security and Medicare.



This last chart shows the difference between what we proposed, the $750 billion tax cut, not counting the interest, the associated interest cost. The President's proposal was for $1.6 trillion of tax cut, not counting the associated interest cost.



So that is where we are. Obviously this leaves us with a very substantial challenge. And I think we are up to that. We certainly have dealt with fiscal difficulties before, and we have got somebody here as the ranking member of this committee who has deep experience and who we will be looking to for his wise advice as we proceed.

Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Well, thank you very much, Mr. Chairman and fellow Senators. I think it is a testimonial to the U.S. Senate that so many Senators are present today. For an opening hearing, frequently Senators don't assume that it is necessary that they be here. But I think this hearing, if we do it right, kind of sets the stage as to where and how we are going to proceed with the resources of the people of this great Nation in a very, very difficult and arduous time.

Let me just tell you why I think current issues are difficult. First of all, we have at the same time, for all of us as Senators and our President, a war and a recession. There may be a few people in the U.S. Senate that think we shouldn't be in that war. I haven't heard from any yet, so I am going to assume that one thing that is very, very unique is that we are in a war.

Now, either of those two events occurring in the United States give rise to some very exceptional concerns. If you are in a war, you most likely don't follow budgetary rules in terms of expenditures and the like that you would if you were not in a war. So if you are going to talk about the fact that we should not have deficits, remember that normally it is pretty difficult to conduct a war and not have some deficits.

The second thing we have is a recession. I am so grateful to the people of the United States from what I see in most polls, Senator Gramm. The American people see right through the argument that our President is responsible for this recession, when an overwhelming percentage of the American people believe that recessions occur from time to time and we have now got one. And for all of the talk about our President being the person, the primary motivator of this because of tax cuts, we can continue to talk about it. But I think we ought to move to another subject if we want to talk about anything that is politically relevant to the American people.

So the important thing is to take a good look as to where we are right now and what we ought to think about in terms of our governing responsibility.

One thing I want to remind those who listened to the arguments of my good friend, the Chairman, is that he moves back and forth between 1 year and 10 years. So it would seem to me that everybody ought to understand we have to produce a 1-year budget here in terms of a binding budget. Whether we produce a 5-year one accompanying it or a 10-year one—it is my understanding the Administration is probably going to produce a 5-year budget this year. I hope that is the case.

In any event, let me borrow a few words to tell you what I think is *not* the case. On January the 4th, the majority leader, Senator Daschle, said that "Tax cuts enacted on a bipartisan basis last year caused the surplus to disappear and made the recession worse." This is not only ridiculous, but it also sets us off on a highly partisan path when on that issue we need not have a partisan situation. The facts do not support the majority leader's position, and the American people apparently have not bought the majority leader's position. These are the comments of political, not economic, advisers. Remember that the economy is measured by quarterly rates of growth. Industrial production and other factors actually began to decline in the summer of 2000. That is before this President was in office. There was no question about it. And everybody was looking at it right smack in the face deciding to do what they could and what they should. Whatever the President wanted, he tried to do. Nonetheless, we were looking at a recession. It continued on and eventually reached a full definitional recession just a little less than 1 year ago.

Then about a week ago, another Senator, Senator Kennedy, whom I consider a friend, said that "We should repeal elements of last year's tax cut law and spend the increased taxes on more government." I say to my friend, the Chairman of this committee, as we begin the process of crafting a budget for the upcoming year, if your leadership and the Democratic Caucus are going to insist on tax increases, then we will have a very, very long year in the budget trenches.

We do not have a lot of time. Our legislative time is short because it is an election year. And I fear that if the majority pursues such an agenda of tax increases, then even if you could pass such a resolution out of this committee or out of the Senate, you would probably fail to get an agreement with your House Budget Committee counterparts, and we would go through a very lengthy and arduous debate, which would conclude, I believe, with no achievement at all.

So I still believe in the process that we are involved in, and I still believe it is the best mechanism we have to set fiscal policy. The policy priorities before the country at this time seem very clear to me.

Let me suggest that we are probably going to be engaged in a debate on priorities like we have never had before. First, we are going to have to say what is our highest priority in terms of spending money even if it is money that puts us in deficit. And I believe—I will propose—and I think if you propose it, you will win; if I do, I will win—that the highest priority is the war and the military needs of our country. If that has to go up anything like 9 or 10 percent or 12 percent, I believe that we will have to do that.

Second, homeland defense will be the second priority, and I have no way of judging what that will cost, Mr. Chairman, but I believe the President will submit a homeland defense proposal. And so I think the Number 1 and Number 2 proposals will be set forth in that way for us.

Then the third you alluded to very clearly, and that is to do something about the slow growth of the economy by passing very soon an economic stimulus package. I hope we do that and do it seriously. I am glad to hear that the majority leader has suggested that we do something and do it quickly. He wasn't in that frame of mind at the end of the first session of this Congress. Whatever, he now seems to say let's do something.

What I have seen is his current proposal does not seem to me to be adequate, but maybe he has some other political strategy, Mr. Chairman, that I am not aware of that accompanies his four-point "stimulus" proposal. Nonetheless, we are going to spend in terms of our third priority on incentives to build back the American economy.

There is no doubt in my mind that the fourth priority then will be the rest of government, and, frankly, I believe there will be money for some increases in the rest of government. But I do believe that we can't do everything, and we will have a significant deficit, the way I look at it, this year, this coming year, the year we are going to be budgeting. The choice is between having deficit and providing money for those priorities or trying to not have a deficit. If we choose not to have a decifit, we are not accepting those priorities that we must spend more money this coming year than we spent this year by a substantial amount and that we need an economic stimulus of a significant amount.

That is how I see the set-up for this committee. I see members now on this committee that I have grown to know, even though we haven't been meeting on a regular basis because there was not anything to do. But I compliment a number of you on both sides of the aisle because you have expressed yourself with reference to the economy and how you help the economy in ways, a number of you, that I am very proud to be associated with. Clearly, on the Democrat side, there are some new Senators that are very informed and prepared on the American economy and what is the best thing to do. I know one of our new members who comes from the State of New Jersey and sits at the last seat surely understands the economy in ways that we ought to all be proud to have when a newcomer joins this committee.

So, with that, I am prepared, we are prepared. We have a lot of people interested on our side in helping, sitting down and getting our work done, Mr. Chairman. I believe you when you say we have got to work and work as quickly as we can. And I think you are implicitly saying to us this is not going to be a process where anybody tries to sneak anything over on anybody. This is going to be a rather forthright one. I think we all know what the problems and the issues are, and I thank you for calling an early meeting. I also thank Mr. Crippen and his staff for preparing it, and surely from our standpoint, having been without an office for so long, Mr. Chairman, I believe it is imperative that we thank all of your staff and mine for the wonderful work that they have done in getting us here and getting us into our other offices.

I notice all the staff are kind of excited, Mr. Chairman. I didn't think they loved their work so much, but they do. Maybe it is that they love their work if we do it in the right building or something. But, in any event, I think they are ready to go, and when you have all that put together, I think we have a year when we can get our job done.

Thank you very much.

Chairman CONRAD. I thank the Senator from New Mexico, and we will go to Mr. Crippen. I want to, before we do that, just indicate the rules of the committee, just to remind people. We will proceed based on the longstanding rules of this committee. Before the gavel, we go in seniority order. After the gavel, it is order of arrival. On our side, Senator Hollings will be first. On the Republican side, Senator Grassley will be first, followed by Senator Gramm. On our side, Senator Corzine will follow Senator Hollings.

With that, I want to again assure the ranking member, this Senator, as Chairman of the Budget Committee, has no intention of proposing a tax increase at a time of economic downturn. I don't think that would be wise. I do think it is critical that we think now about how we are going to restore the integrity of the trust funds now that we see, based on the budget plan that is in place, the law that is in place, that we are going to be taking over $1 trillion from Social Security and Medicare Trust Funds to pay for the previously enacted tax cut and for other government expenditures.

With that, again, welcome, Mr. Crippen, and please proceed.

STATEMENT OF DAN L. CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. CRIPPEN. Mr. Chairman, Senator Domenici, members of the committee, I appreciate the opportunity to represent CBO this morning in presenting our current assessment of the economic and budget outlook. As you suggested, Mr. Chairman, what little I know today certainly is a product of hard work of a lot of folks, some of whom are here today as my colleagues.

I might say that I am here today to reveal what appears to be the worst-kept secret in Washington, and that is probably saying something: that is, that our surplus estimates of a year ago have been, shall we say, diminished somewhat.

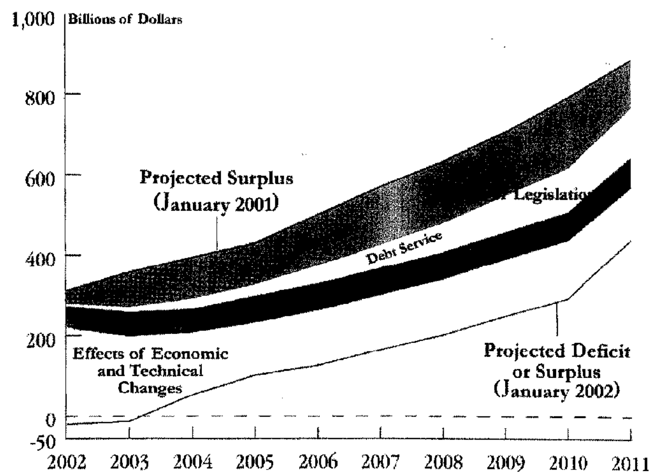
As you said, Mr. Chairman, a year makes a lot of difference. I have heard it said that a year can be an eternity in the field of politics. This year proves it is also true in the pursuit of economics.

As you are all aware, the results we present today are our current best estimate of the economics for the next 10 years and the associated budget outlook, with no change in policy; that is, no increased spending for the war on terrorism or homeland spending, homeland defense, no additional spending for farm programs, no additional reduction in taxes or other stimulus legislation beyond that already in law, no renewals of expiring tax provisions, including last year's tax cut, which is set to expire in 2010. So this, Mr. Chairman, as you know, is a policy-neutral, current-law baseline as best as we can tell it.

These first two charts that Melissa will put up attempt to illustrate, both graphically and numerically, as you have seen in the testimony that we submitted, what has happened to the projected surpluses and why our projections have changed so dramatically [see Figures 1 and 2, attached]. As you said in your opening remarks, Mr. Chairman, the outlook for surpluses over the next 10 years has gone from $5.6 trillion to $1.6 trillion over the comparable period of 2002 to 2011, a reduction of $4 trillion in only a year.

The primary causes of that decline, the diminished performance of the economy and the passage of legislation, vary in importance over the next 10 years. In the near term, the biggest change since last January is indeed due to the economy. Instead of the 3.4 percent real growth in gross domestic product (GDP) we forecasted a year ago, similar at the time to most other forecasters, we now expect GDP to grow by less than 1 percent this year. As a result of that change in economic circumstances and the mostly related technical adjustments associated with it, the balance for our current fiscal year will be something like $240 billion less than we forecast a year ago.

Why CBO's Budget Projections Changed



CBO Outlook (1-02)

Why CBO's Budget Projections Changed
(In billions of dollars)

	2002	2002-2011
January 2001 Projection	**313**	**5,610**
Legislative Changes		
Tax Law	-38	-1,275
Defense Appropriations	-33	-301
Nondefense Appropriations	-11	-249
Debt Service and Other Costs	-9	-595
Subtotal	-91	-2,420
Economic Changes	-148	-929
Technical Changes	-94	-660
Total Changes	-333	-4,008
January 2002 Projection	**-21**	**1,602**

CBO Outlook (1/02)

Legislation enacted since last January will further reduce balances this year by around $90 billion (not counting the associated debt-service costs) one-third of which comes from reduced revenues and two-thirds of which is in increased outlays. Combined, those changes amount to a swing of over $300 billion, as your chart indicated, Mr. Chairman, and they alter our baseline forecast from a $300 billion surplus to a small, perhaps $20 billion deficit. A similar pattern exists for 2003, with a resultant small deficit of $14 billion. By 2004, we forecast the emergence of unified surpluses, with on-budget surpluses developing again only near the end of the decade.

Our projection of changes for the second half of the next 10 years, of course, indicates the reverse. Changes in legislation have more impact than do changes in the economy. By 2011, changes in law since last January directly reduce the surplus estimate by just under $200 billion, $120 billion from revenue loss and $70 billion from increased spending. Changes in the economic outlook and technical assumptions account for an additional $130 billion deterioration in 2011.

Over the 10-year period, as your chart also indicated, Mr. Chairman, changes in the economy account for some 40 percent of the diminution in surpluses while legislation makes up the rest.

This recession and its effects on the budget have been unusual in several respects. First, the downturn was precipitated not by the usual circumstances of demand outstripping supply, which increases inflation and causes a monetary tightening by the Federal Reserve to correct those imbalances; rather, this time a precipitous drop-off in capital spending and inventories by corporations of all types, especially for information technology (IT) products, caused about three-quarters of the decline in GDP growth. While the increase in consumer spending slowed somewhat, it still remained a source of strength through much of the year.

Second, that overinvestment, if you will, was accompanied by a marked decline in equity markets, especially for high-tech stocks, which in turn meant fewer capital gains, a slowdown in capital gains realizations and, therefore, capital gains taxes.

Third, the attacks of September 11th probably exacerbated the recession we were already in. Although most of the initial impact seems to have worn off, at least some industries, such as airlines, have not recovered. The possibility of future attacks has increased uncertainty and led to a significant and growing level of expenditures on security.

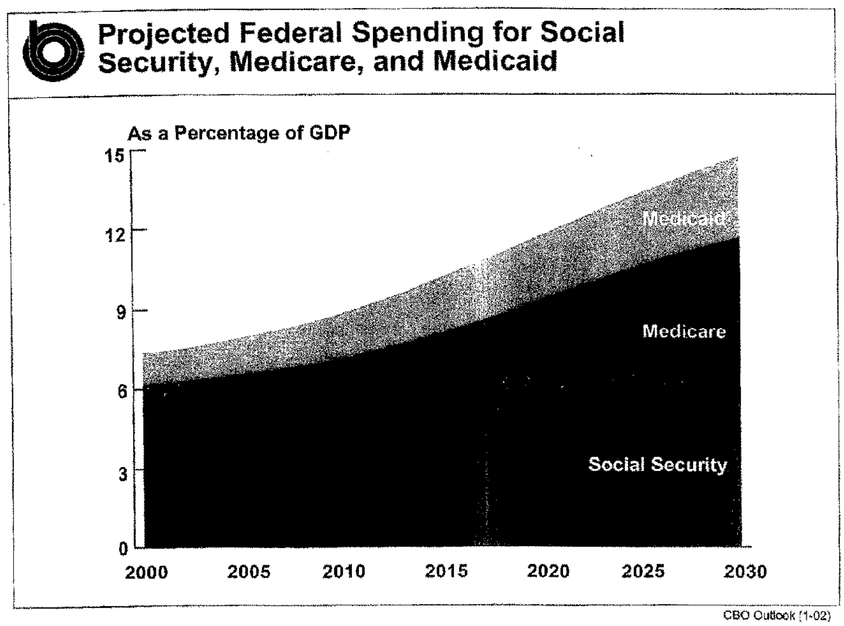
Fourth, our current economic projections alone would not have reduced revenues as much as is implied by this forecast. Revenue collections are running lower than expected, even given the current anemic rate of growth. There are some phenomena here that we don't fully understand, Mr. Chairman. They may be temporary or permanent, but for now we assume them to be largely permanent.

Finally, while not directly related to this downturn, the Bureau of Economic Analysis simultaneously and substantially reduced its estimates for the previous three years, reducing the level of capital investment, for example, which in turn lowered the base of expected growth of the economy.

Given the nature of this recession—that is, the dearth of capital spending—the economy will likely be slow to recover after bottoming out. Only when consumption and inventory needs strain current capacity will it be profitable to invest again in capital stock, and only then will growth in the economy resume its 3 percent potential.

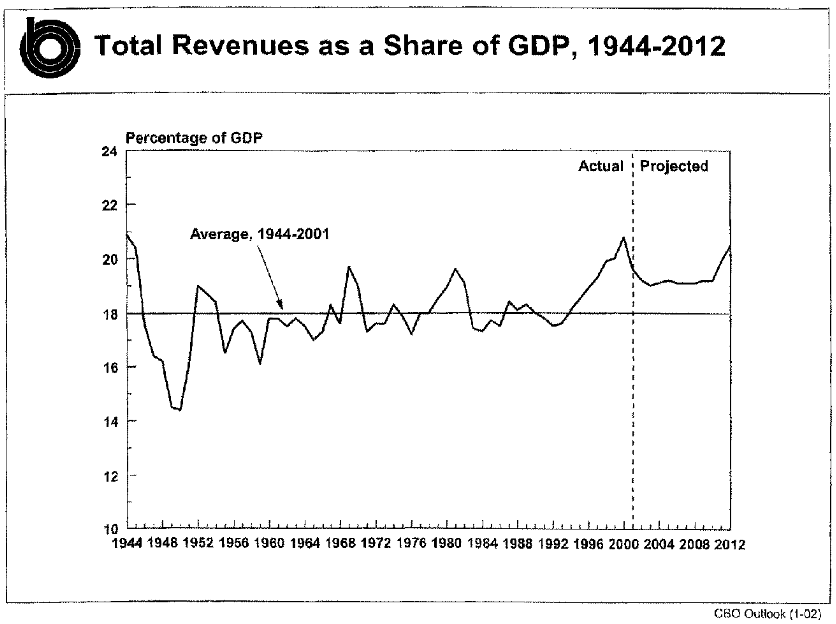
Mr. Chairman, I know the committee has many questions about this forecast and its implications for overall domestic policy, and I won't try to anticipate them at this point. But before I relinquish the floor, I feel compelled to once again remind everyone, just as you have, that the 10-year period in our baseline will only begin to touch on the era of what is likely to be the largest actual, real, not merely projected, fiscal swing in our history. The retirement of my generation will double the number of retirees receiving Federal benefits, while the work force that must support it, that must pay our benefits, will grow only nominally.

What this means, I believe, is found in this poor chart I drag around everywhere I go, namely, that these programs—Social Security, Medicare, and Medicaid—will consume more than twice as much of the economy as is presently the case. There are a number of important implications, I believe, to take away from this chart [see Figure 3, below].



First, there are really only two moving parts to this phenomenon: spending on the elderly and the size of the economy. While the operation of the trust funds is not wholly irrelevant, the most important thing we can do for our children and grandchildren is grow the economy, not the trust funds, and perhaps accept lower benefits for ourselves. When the day comes to collect my Social Security check, it matters less how the cash that I will spend and consume is generated than how much of what my kids are producing I will demand they hand over to me. Whether it is financed by taxes on them at the time, selling them stocks, or providing less in other government programs for them, they will fund my benefit.

Finally, this growing wedge will consume nearly the amount of resources we now expend for all Federal programs. That means, quite simply, that other programs will need to be cut, taxes raised, or debt issued to the tune of nearly 10 percent of GDP. As this last chart illustrates, since World War II, the average Federal tax take has been 18 percent of GDP [see Figure 4, below]. Even with last year's tax cut, revenues will remain well above the average. Put more starkly, Mr. Chairman, the extremes of what will be required to address our retirement needs are these: we will have to increase borrowing by very large, likely unsustainable, amounts; raise taxes to 30 percent of GDP—obviously unprecedented in our history; or eliminate most of the rest of government as we know it. That is the dilemma that faces us in the long run, Mr. Chairman, and these next 10 years will only be the beginning.



Thank you.

PREPARED STATEMENT OF DAN L. CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, Senator Domenici, and members of the committee, I am pleased to be here today to discuss the current outlook for the budget and the economy. The Congressional Budget Office (CBO) will release its report on that topic, *The Budget and Economic Outlook: Fiscal Years 2003–2012*, on January 31. My testimony today will summarize that report.

The economic recession and recent laws have combined to sharply reduce the budget surpluses projected a year ago. In January 2001, CBO projected that under the laws and policies then in force, the Federal Government would run surpluses in fiscal years 2002 through 2011 totaling $5.6 trillion.[1] In CBO's new projections, that cumulative surplus has fallen to $1.6 trillion—a drop of $4 trillion (see Table 1).

[1] That projection appeared in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002–2011* (January 2001).

Table 1. Changes in CBO's Baseline Projections of the Surplus Since January 2001

[in billions of dollars]

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2002-2006	Total, 2002-2011
Total Surplus as Projected in January 2001	313	359	397	433	505	573	635	710	796	889	2,007	5,610
Changes.												
Legislative.												
Tax Act (a)	-38	-91	-108	-107	-135	-152	-160	-168	-187	-130	-479	-1,275
Discretionary spending	-44	-49	-52	-54	-56	-57	-58	-59	-60	-61	-255	-550
Other	-4	-6	-5	-3	-4	-2	-2	-2	-2	-2	-23	-33
Debt service (b)	-5	-12	-22	-32	-44	-57	-72	-88	-106	-124	-114	-562
Subtotal	-91	-158	-186	-197	-238	-268	-293	-317	-355	-317	-870	-2,420
Economic	-148	-131	-95	-81	-75	-75	-76	-79	-82	-88	-530	-929
Tehnical (c)	-94	-84	-62	-51	-64	-64	-65	-64	-65	-45	-356	-660
Total Changes	-333	-373	-343	-330	-377	-406	-433	-460	-502	-450	-1,757	-4,008
Total Surplus or Deficit (-) as Projected in January 2002	-21	-14	54	103	128	166	202	250	294	439	250	1,602
Memorandum:.												
Changes in the Surplus by Type of Discretionary Spending.												
Defense	-33	-29	-29	-29	-29	-29	-30	-30	-31	-32	-149	-301
Nondefense	-11	-20	-23	-25	-26	-28	-28	-29	-29	-30	-106	-249

Source: Congressional Budget Office.

Note: For purposes of comparison, this table shows projections for 2002 through 2011 because that was the period coverd by CBO's January 2001 baseline. The current projection period extends from 2003 through 2012.

a. The Economic Growth and Tax Relief Reconciliation Act of 2001, which was estimated at the time of enactment to reduce revenues by $1,186 billion and increase outlays by $88 billion between 2002 and 2011.

b. Reflects only the change in debt-service costs that results fron legislative actions. Other effect on debt-service costs are included under economic and technical changes.

c. Technical changes are revisions that are not attributable to new legislation or to changes in the components of CBO's economic forecast.

About 60 percent of that decline results from legislation—the tax cuts enacted in June and additional discretionary spending—and from its effect on the cost of paying interest on the Federal debt. Changes in the economic outlook and various technical revisions since last January account for the other 40 percent of that decline.

For both 2002 and 2003, CBO now projects that, instead of surpluses, the total budget will show small deficits, if current policies remain the same and the economy follows the path that CBO is forecasting. In 2001, by contrast, the Federal Government recorded a surplus of $127 billion (see Table 2).

The deficit projected for this year—$21 billion—represents a change of more than $300 billion from last January's projection. Over 70 percent of that reduction results from the weak economy and related technical factors, which have considerably lowered the revenues expected for this year and next.

Table 2.
The Budget Outlook Under Current Policies (In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
On-Budget Surplus or Deficit (-)	-33	-181	-193	-141	-108	-99	-76	-56	-23	4	131	319	-617	-242
Off-Budget Surplus[a]	161	160	178	195	212	227	242	258	274	290	307	322	1,054	2,505
Total Surplus or Deficit (-)	127	-21	-14	54	103	128	166	202	250	294	439	641	437	2,263
Debt Held by the Public (End of year)	3,320	3,380	3,410	3,373	3,288	3,177	3,027	2,840	2,605	2,325	1,900	1,273	n.a.	n.a.
Memorandum:														
Total Surplus or Deficit (-) as a Percentage of GDP	1.3	-0.2	-0.1	0.5	0.8	1.0	1.2	1.4	1.7	1.9	2.7	3.7	0.7	1.6
Debt Held by the Public (End of year) as a Percentage of GDP	32.7	32.8	31.3	29.2	27.0	24.8	22.5	20.0	17.5	14.8	11.5	7.4	n.a.	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

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

For the current 10-year projection period, 2003 through 2012, CBO estimates a total surplus of nearly $2.3 trillion. However, almost half of that total comes from the surpluses projected for 2011 and 2012—the last 2 years of the projection period and thus the most uncertain. The surpluses for those years also reflect the scheduled expiration in December 2010 of the tax cuts enacted last June.

In CBO's new baseline, the off-budget accounts (which reflect the spending and revenues of Social Security and the Postal Service) run surpluses throughout the projection period. In the on-budget accounts, by contrast, surpluses do not reemerge until 2010.

CBO's baseline projections are intended to serve as a neutral benchmark against which to measure the effects of possible changes in tax and spending policies. They are constructed according to rules set forth in law and long-standing practices and are designed to project Federal revenues and spending under the assumption that current laws and policies remain unchanged. Thus, these projections will almost certainly differ from actual budget totals: the economy may not follow the path that CBO projects, and lawmakers are likely to alter the Nation's tax and spending policies. Therefore, CBO's baseline should be viewed not as a forecast or prediction of future budgetary outcomes but simply as the agency's best judgement of how the economy and other factors will affect Federal revenues and spending under current law.

THE BUDGET OUTLOOK

If current policies remain in place, CBO projects, the budget will be in deficit for the next 2 years. Those deficits are expected to be quite small, amounting to only 0.2 percent of the Nation's gross domestic product (GDP) in 2002 and 0.1 percent of GDP in 2003. After that, surpluses are projected to reemerge and gradually increase.

For the 5-years from 2003 through 2007, CBO projects a cumulative surplus of $437 billion. That figure represents off-budget surpluses totaling more than $1 trillion offset by on-budget deficits that add up to $617 billion. For the 10-year period through 2012, the total budget surplus under current policies is projected to approach $2.3 trillion. Again, that amount is made up of surpluses in Social Security ($2.5 trillion) offset by a cumulative on-budget deficit ($242 billion). Without the scheduled expiration of tax-cut provisions in 2010, the total 10-year budget surplus would fall to $1.6 trillion.

The total surplus is projected to equal 1 percent of GDP by 2006 and grow to 3.7 percent of GDP by 2012. Estimates of large surpluses should be viewed cautiously, however, because future economic developments and estimating inaccuracies could change the outlook substantially. In addition, future legislative actions are almost certain to alter the budgetary picture.

CHANGES IN THE PAST YEAR

As an illustration of how quickly the budget outlook can change, CBO's projection of the cumulative surplus for 2002 through 2011 has plunged by $4 trillion in just 1 year (see Table 1).[2] Some $2.4 trillion of that drop can be attributed to legislative actions. The legislation with the largest effect was the Economic Growth and Tax Relief Reconciliation Act of 2001, enacted in June. That law is estimated to reduce surpluses by nearly $1.3 trillion over 10 years (not including associated debt-service costs).

Additional discretionary spending since last January accounts for another $550 billion reduction in the projected surplus for the 2002–2011 period. That amount stems from both regular and supplemental appropriations. CBO's January 2001 baseline assumed that discretionary budget authority for 2002 would total $665 billion.[3] The actual amount appropriated for 2002 in the 13 regular appropriation acts totaled $691 billion. In addition, the Congress and the President enacted $20 billion in supplemental budget authority in December as part of their response to the terrorist attacks of September 11—thereby generating a total of $711 billion in budget authority for 2002, $45 billion more than CBO assumed last January.

Under the provisions of the Balanced Budget and Emergency Deficit Control Act of 1985, CBO's baseline assumes that annual appropriations for discretionary programs continue at their current level, increasing only by the rates of inflation pro-

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[2] About 45 percent of that reduction results from changes made since CBO issued its updated *Budget and Economic Outlook* in August. The drop since August totals $1.8 trillion and is attributed, in relatively equal measures, to legislative, economic, and technical changes.

[3] That figure was calculated by assuming that the amount appropriated for the base year of 2001 would grow at specified rates of inflation.

jected for each year. As a result of the appropriations enacted for 2002, projections of discretionary spending in the current baseline begin at a level that is $45 billion higher than a year ago.

Furthermore, two supplemental appropriation laws enacted in fiscal year 2001—one for defense personnel and readiness programs and another in immediate response to the attacks of September 11—will generate outlays totaling around $25 billion in 2002 and beyond. However, budget authority from actions in 2001 is not carried forward into the baseline projections for future years because those appropriations occurred before the current year.

Overall, legislated reductions in revenues, additional discretionary spending, and other laws with smaller budgetary effects have reduced projected surpluses—and thereby increased the government's borrowing needs—by $1,858 billion for 2002 through 2011. That increased borrowing is projected to result in an extra $562 billion in net interest costs over the 10-year period.

Changes in the economic outlook since January 2001 account for another $929 billion decline in the 10-year surplus. About three-quarters of that total reflects lower revenue projections, mostly resulting from the substantially weaker economic growth expected in the near term and the slightly lower average growth rates projected for the following several years. Much of the rest of the decline attributable to the economic outlook represents additional debt-service costs resulting from the reduction in anticipated revenues.

Technical changes—those not driven by new legislation or by changes in CBO's economic forecast—have reduced the projected 10-year surplus by a total of $660 billion since last January. As with the economic changes, revenues account for over 75 percent of the technical changes, and debt service accounts for much of the rest. The technical changes to revenues stem primarily from revised projections of capital gains realizations and adjustments for lower-than-expected tax collections in recent months.

HOMELAND SECURITY

Since the attacks of September 11, Federal agencies, State and local governments, and the private sector have perceived a heightened threat to the United States and a need to commit more resources to homeland security. On the Federal level, legislation following the attacks increased the budget authority provided for such security from $17 billion in 2001 to $22 billion for 2002. What level of resources to commit to homeland security will undoubtedly be a key issue as the Congress and the President make decisions about spending and other policies this year.

THE OUTLOOK FOR FEDERAL DEBT

In the January 2001 *Budget and Economic Outlook*, CBO estimated that Federal debt held by the public would reach a level in 2006 that would allow the Treasury to retire all of the debt available for redemption. At that time, CBO also projected that the statutory ceiling on all Federal debt (which includes debt held by government accounts) would not be reached until 2009. Now, CBO estimates that debt held by the public will not be fully redeemed within the 10-year projection period and that the current debt ceiling will be reached in the next few months. Nevertheless, if the surpluses projected in the current baseline materialize, debt held by the public will fall to about 15 percent of GDP in 2010—its lowest level since 1917.

THE ECONOMIC OUTLOOK

In CBO's opinion, the most likely path for the economy is a mild recession that may already have reached its nadir. CBO expects the annual growth rate of real (inflation-adjusted) GDP to accelerate from –0.2 percent in 2001 (measured from the fourth quarter of calendar year 2000 to the fourth quarter of 2001) to 2.5 percent in 2002 and to accelerate further to 4.3 percent in 2003.

Some unusual features of the current recession will cause it to be mild, CBO believes. Chief among those features are the rapidity of policymakers' responses, the moderating behavior of prices, and an early reduction in businesses' inventories. In less than 1 year, the Federal Reserve has cut the Federal funds rate 11 times—from 6.5 percent to 1.75 percent. Also, the tax cuts enacted in June prevented consumption from slowing more than it might have otherwise, and additional Federal spending in response to the terrorist attacks will boost GDP in 2002. Lower prices for oil and natural gas and mild price increases for other items are supporting consumption by boosting real disposable income. Furthermore, businesses began to reduce inventories earlier in this recession than they did in past downturns, which may mean that fewer cuts in inventories remain than at this stage of the typical recession.

CBO projects that weak demand in the short run will translate into weak employment, pushing the unemployment rate higher for the next several quarters while restraining inflation. With growth of real GDP near zero early this year, the unemployment rate is expected to increase to 6.1 percent in calendar year 2002 from 4.8 percent last year (see Table 3). The rate of inflation faced by consumers is forecast to fall from 2.9 percent last year to 1.8 percent in 2002. Lower oil prices account for most of the projected decline in inflation, although the recession also plays a role. As oil prices stabilize in CBO's forecast, inflation bounces back to 2.5 percent in 2003.

Table 3.
CBO's Economic Forecast for 2002 and 2003

	Estimated	Forecast	
	2001	2002	2003
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP	1.7	4.2	6.5
Real GDP	-0.2	2.5	4.3
Calendar Year Average			
Real GDP (Percentage change)	1.0	0.8	4.1
Consumer Price Index (Percentage change)[a]	2.9	1.8	2.5
Unemployment Rate (Percent)	4.8	6.1	5.9
Three-Month Treasury Bill Rate (Percent)	3.4	2.2	4.5
Ten-Year Treasury Note Rate (Percent)	5.0	5.0	5.5

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

a. The consumer price index for all urban consumers.

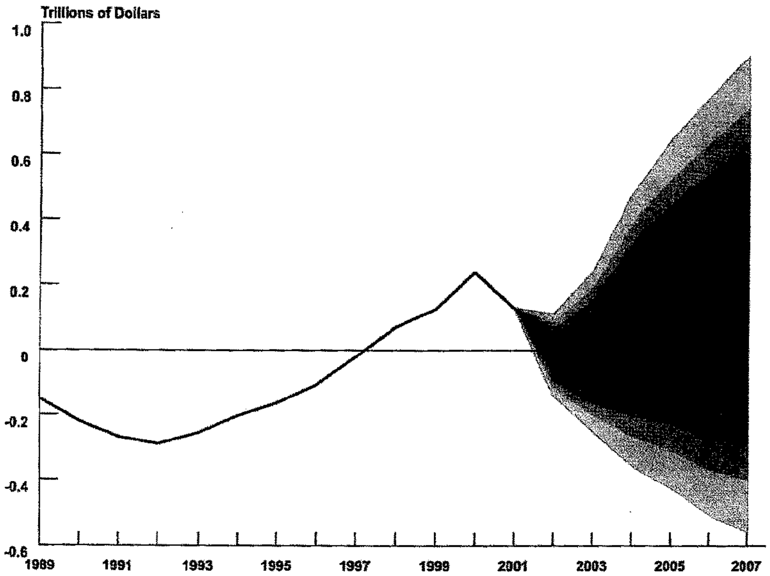
Looking out through 2012, CBO expects the growth of real GDP to average 3.1 percent during the 2002–2012 period—roughly the same as it projected last January for the 2002–2011 period. Nonetheless, the level of real GDP is lower each year than in last January's projections, primarily because actual GDP ended up much lower in 2001 than CBO had expected a year ago.

UNCERTAINTY OF THE PROJECTIONS

CBO's baseline projections represent the midrange of possible outcomes based on past and current trends and the assumption that current policies do not change. But considerable uncertainty surrounds those projections for two reasons. First, future legislation is likely to alter the paths of Federal spending and revenues. CBO does not predict legislation—indeed, any attempt to incorporate future legislative changes would undermine the usefulness of the baseline as a benchmark against which to measure the effects of such changes. Second, the U.S. economy and the Federal budget are highly complex and are affected by many economic and technical factors that are difficult to predict. As a result, actual budgetary outcomes will almost certainly differ from CBO's baseline projections.

In view of such uncertainty, the outlook for the budget can best be described as a fan of probabilities around the point estimates presented as CBO's baseline (see Figure 1). Not surprisingly, those probabilities widen as the projection period extends. As the fan chart makes clear, projections that are quite different from the baseline have a significant probability of coming to pass.

Figure 1.
Uncertainty in CBO's Projections of the Total Budget Surplus Under Current Policies



SOURCE: Congressional Budget Office.

NOTES: This figure shows the estimated likelihood of alternative projections of the surplus under current policies. The calculations are based on CBO's past track record. CBO's baseline projections fall in the middle of the darkest area. Under the assumption that policies do not change, the probability is 10 percent that actual surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual surpluses will of course be affected by legislation enacted during the next 10 years, including decisions about discretionary spending. The effects of future legislation are not included in this figure.

An explanation of how this probability distribution was calculated will appear shortly on CBO's Web site (www.cbo.gov).

CBO's Baseline Budget Projections

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
							In Billions of Dollars							
Revenues														
Individual income taxes	994	947	998	1,059	1,114	1,162	1,228	1,305	1,387	1,477	1,673	1,841	5,562	13,245
Corporate income taxes	151	179	175	199	235	246	260	275	289	303	319	335	1,115	2,635
Social insurance taxes	694	710	748	789	832	869	908	948	994	1,045	1,097	1,151	4,146	9,381
Other	152	146	149	159	161	170	172	179	186	183	188	223	811	1,769
Total	1,991	1,983	2,070	2,206	2,342	2,447	2,568	2,706	2,856	3,008	3,277	3,549	11,633	27,030
On-budget	1,484	1,464	1,525	1,632	1,739	1,816	1,907	2,014	2,130	2,243	2,474	2,706	8,620	20,187
Off-budget	508	518	545	574	602	631	661	693	727	764	803	842	3,014	6,842
Outlays														
Discretionary spending	649	733	764	784	808	824	841	866	888	910	937	953	4,021	8,575
Mandatory spending	1,095	1,188	1,248	1,292	1,362	1,428	1,508	1,602	1,701	1,809	1,933	2,023	6,837	15,904
Offsetting receipts	-87	-88	-101	-113	-119	-115	-122	-129	-136	-143	-152	-160	-570	-1,289
Net interest	206	170	174	188	188	182	175	165	153	138	120	92	908	1,577
Total	1,864	2,003	2,085	2,152	2,238	2,319	2,402	2,504	2,606	2,714	2,838	2,908	11,196	24,767
On-budget	1,517	1,645	1,718	1,774	1,848	1,915	1,983	2,069	2,153	2,240	2,343	2,387	9,237	20,429
Off-budget	347	358	367	379	391	405	419	434	453	474	495	521	1,960	4,337
Surplus or Deficit (-)	127	-21	-14	54	103	128	166	202	250	294	439	641	437	2,263
On-budget	-33	-181	-193	-141	-108	-99	-76	-56	-23	4	131	319	-617	-242
Off-budget	161	160	178	195	212	227	242	258	274	290	307	322	1,054	2,505
Memorandum:														
Gross Domestic Product	10,150	10,315	10,890	11,556	12,168	12,803	13,468	14,166	14,897	15,664	16,469	17,314	60,884	139,394
							As a Percentage of GDP							
Revenues														
Individual income taxes	9.8	9.2	9.2	9.2	9.2	9.1	9.1	9.2	9.3	9.4	10.2	10.6	9.1	9.5
Corporate income taxes	1.5	1.7	1.6	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.8	1.9
Social insurance taxes	6.8	6.9	6.9	6.8	6.8	6.8	6.7	6.7	6.7	6.7	6.7	6.6	6.8	6.7
Other	1.5	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.2	1.2	1.1	1.3	1.3	1.3
Total	19.6	19.2	19.0	19.1	19.2	19.1	19.1	19.1	19.2	19.2	19.9	20.5	19.1	19.4
On-budget	14.6	14.2	14.0	14.1	14.3	14.2	14.2	14.2	14.3	14.3	15.0	15.6	14.2	14.5
Off-budget	5.0	5.0	5.0	5.0	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Outlays														
Discretionary spending	6.4	7.1	7.0	6.8	6.6	6.4	6.2	6.1	6.0	5.8	5.7	5.5	6.6	6.2
Mandatory spending	10.8	11.5	11.5	11.2	11.2	11.2	11.2	11.3	11.4	11.5	11.7	11.7	11.2	11.4
Offsetting receipts	-0.9	-0.9	-0.9	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Net interest	2.0	1.7	1.6	1.6	1.5	1.4	1.3	1.2	1.0	0.9	0.7	0.5	1.5	1.1
Total	18.4	19.4	19.1	18.6	18.4	18.1	17.8	17.7	17.5	17.3	17.2	16.8	18.4	17.8
On-budget	14.9	16.0	15.8	15.3	15.2	15.0	14.7	14.6	14.5	14.3	14.2	13.8	15.2	14.7
Off-budget	3.4	3.5	3.4	3.3	3.2	3.2	3.1	3.1	3.0	3.0	3.0	3.0	3.2	3.1
Surplus or Deficit (-)	1.3	-0.2	-0.1	0.5	0.8	1.0	1.2	1.4	1.7	1.9	2.7	3.7	0.7	1.6
On-budget	-0.3	-1.8	-1.8	-1.2	-0.9	-0.8	-0.6	-0.4	-0.2	*	0.8	1.8	-1.0	-0.2
Off-budget	1.6	1.6	1.6	1.7	1.7	1.8	1.8	1.8	1.8	1.9	1.9	1.9	1.7	1.8

SOURCE: Congressional Budget Office.

NOTE: * = between zero and 0.05 percent of GDP.

CBO's Baseline Projections of Discretionary Spending (In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Budget Authority														
Defense	331	348	357	367	376	386	396	406	417	428	439	451	1,881	4,022
Nondefense	331	363	376	385	394	404	414	425	436	447	459	470	1,973	4,211
Total	662	711	733	751	770	790	810	831	853	875	898	921	3,854	8,233
Outlays														
Defense	306	351	356	363	375	381	387	401	411	422	437	441	1,862	3,974
Nondefense	343	381	408	421	433	443	454	465	476	488	500	512	2,159	4,600
Total	649	733	764	784	808	824	841	866	888	910	937	953	4,021	8,575

SOURCE: Congressional Budget Office.

NOTES: CBO's baseline projections assume that discretionary spending grows at the rate of inflation after 2002, using the inflators specified in the Balanced Budget and Emergency Deficit Control Act of 1985 (the gross domestic product deflator and the employment cost index).

In CBO's projections, discretionary outlays always exceed budget authority because of spending from the Highway Trust Fund and the Airport and Airways Trust Fund, which is subject to obligation limitations in appropriation acts. The budget authority for such programs is provided in authorizing legislation and is not considered discretionary. Another reason outlays exceed budget authority is that outlays include spending from appropriations provided in previous years.

CBO's Current and Previous Economic Projections for Calendar Years 2001 Through 2011

	Estimated 2001	Forecast 2002	Forecast 2003	Projected Annual Average 2004-2007	Projected Annual Average 2008-2011
Nominal GDP (Billions of dollars)					
January 2002	10,193	10,422	11,063	13,639[a]	16,676[b]
January 2001	10,446	11,029	11,623	14,100[a]	17,132[b]
Nominal GDP (Percentage change)					
January 2002	3.2	2.2	6.1	5.4	5.2
January 2001	4.7	5.6	5.4	4.9	5.0
Real GDP (Percentage change)					
January 2002	1.0	0.8	4.1	3.3	3.1
January 2001	2.4	3.4	3.3	3.0	3.1
GDP Price Index (Percentage change)					
January 2002	2.2	1.4	2.0	2.0	2.0
January 2001	2.3	2.1	2.0	1.9	1.9
Consumer Price Index[c] (Percentage change)					
January 2002	2.9	1.8	2.5	2.5	2.5
January 2001	2.8	2.8	2.7	2.5	2.5
Unemployment Rate (Percent)					
January 2002	4.8	6.1	5.9	5.2	5.2
January 2001	4.4	4.5	4.5	4.8	5.2
Three-Month Treasury Bill Rate (Percent)					
January 2002	3.4	2.2	4.5	4.9	4.9
January 2001	4.8	4.9	5.0	4.9	4.9
Ten-Year Treasury Note Rate (Percent)					
January 2002	5.0	5.0	5.5	5.8	5.8
January 2001	4.9	5.3	5.5	5.7	5.8
Tax Bases (Percentage of GDP)					
Corporate book profits					
January 2002	6.9	6.1	7.0	7.9	8.1
January 2001	8.9	8.5	8.4	8.1	8.0
Wages and salaries					
January 2002	50.0	50.3	50.1	49.3	48.9
January 2001	48.2	48.2	48.2	48.1	48.0

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

NOTES: CBO's January 2001 projections for GDP and its components were based on data from the national income and product accounts before the accounts were revised in July 2001.

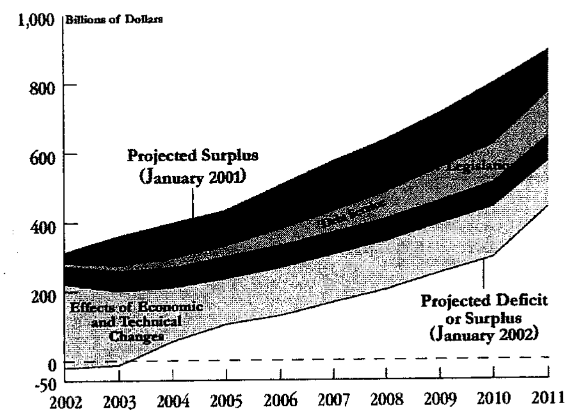
Percentage changes are year over year.

a. Level of GDP in 2007.

b. Level of GDP in 2011.

c. The consumer price index for all urban consumers.

Why CBO's Budget Projections Changed

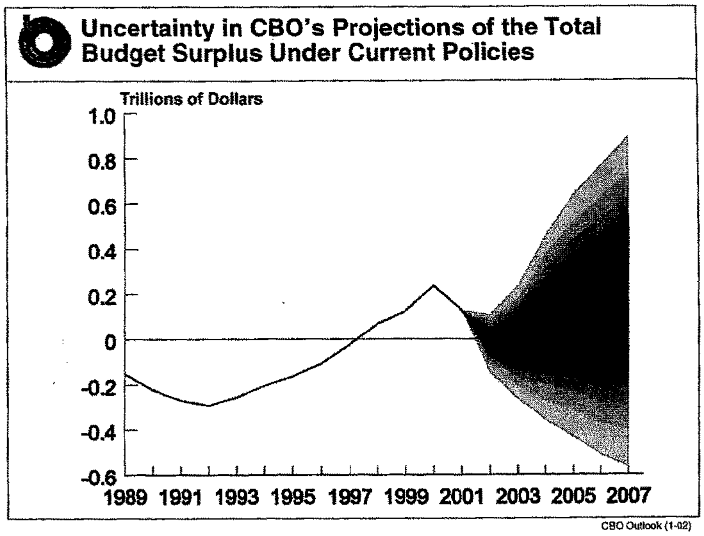


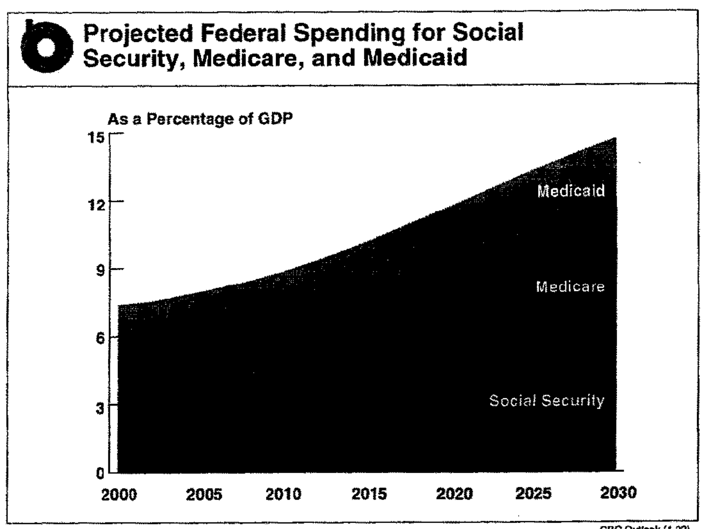
CBO Outlook (1-02)

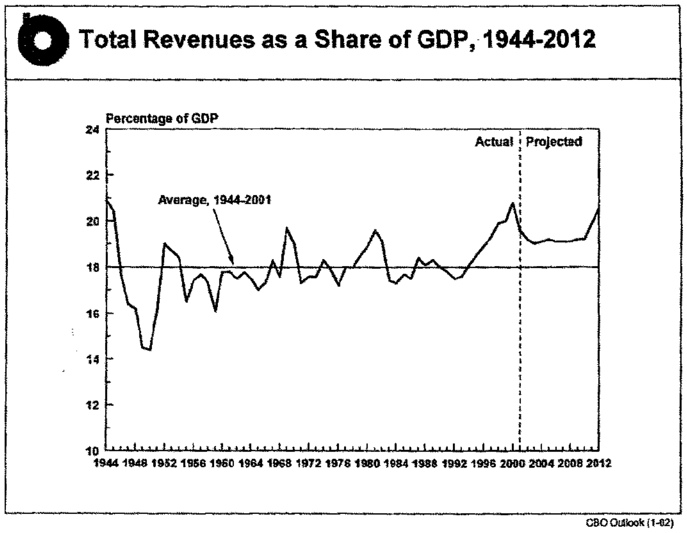
Why CBO's Budget Projections Changed
(In billions of dollars)

	2002	2002-2011
January 2001 Projection	**313**	**5,610**
Legislative Changes		
Tax Law	-38	-1,275
Defense Appropriations	-33	-301
Nondefense Appropriations	-11	-249
Debt Service and Other Costs	-9	-595
Subtotal	-91	-2,420
Economic Changes	-148	-929
Technical Changes	-94	-660
Total Changes	-333	-4,008
January 2002 Projection	**-21**	**1,602**

CBO Outlook (1/02)


Uncertainty in CBO's Projections of the Total Budget Surplus Under Current Policies
Trillions of Dollars
1.0
0.8
0.6
0.4
0.2
0
-0.2
-0.4
-0.6
1989 1991 1993 1995 1997 1999 2001 2003 2005 2007
CBO Outlook (1-02)


Projected Federal Spending for Social Security, Medicare, and Medicaid
As a Percentage of GDP
15
12
9
6
3
0
Medicaid
Medicare
Social Security
2000 2005 2010 2015 2020 2025 2030
CBO Outlook (1-02)



Total Revenues as a Share of GDP, 1944-2012
Percentage of GDP
24
22
20
18
16
14
12
10
Average, 1944-2001
Actual
Projected
1944 1948 1952 1956 1960 1964 1968 1972 1976 1980 1984 1988 1992 1996 2000 2004 2008 2012
CBO Outlook (1-02)

THE LONG-TERM OUTLOOK

Despite the sizable surpluses projected for the later years of CBO's 10-year budget outlook, long-term pressures on spending loom just over the horizon. Those pressures result from the aging of the U.S. population (large numbers of baby boomers will start becoming eligible for Social Security retirement benefits in 2008 and for Medicare in 2011), from increased life spans, and from rising costs for Federal health care programs. According to midrange estimates, if current policies continue, spending on Social Security, Medicare, and Medicaid combined will nearly double by 2030, to almost 15 percent of GDP.

Taking action sooner rather than later to address long-term budgetary pressures can make a significant difference. In particular, policies that encourage economic growth—such as running budget surpluses to boost national saving and investment, enacting tax and regulatory policies that encourage work and saving, and focusing more government spending on investment rather than on current consumption—can help by increasing the total amount of resources available for all uses.

Chairman CONRAD. Thank you very much, Director Crippen, and thank you especially for those final notes on what it is that we face in the long run, because the very harsh reality is that in the future, Congress is going to be faced with incredibly difficult choices—either massive cuts in benefits, massive tax increases, massive increases in debt, or some combination, none of which is desirable.

That is the hard reality, and unfortunately, we have lost part of the opportunity we had to address those questions by fiscal mistakes that I believe were made last year, incredibly serious mistakes that deprive us of the opportunity to have the resources to fully prepare for what we all know is to come. And that is not a projection. As you indicated, the baby boom generation is born, they are alive today, they are going to retire, they are going to be eligible for Social Security and Medicare, and we are going to face extraordinarily difficult challenges in meeting those demands.

I think we should restate the point that you made in your testimony. These estimates of future surpluses that you have made now, which show a $4 trillion reduction from what was made just 1 year ago, do not include changes in policy going forward. Isn't it correct that this does not include the President's proposal for increased funding for defense?

Mr. CRIPPEN. Yes, Mr. Chairman. We have not, of course, seen the President's budget yet, but if there is an increase over our baseline, it is certainly not included here.

Chairman CONRAD. And there wouldn't be in these projections any funding for additional resources for homeland security that we have been told the President will send us.

Mr. CRIPPEN. No, Mr. Chairman. We have included in the baseline the second $20 billion, of course, in supplemental appropriations that was enacted just before you all retired last year.

Chairman CONRAD. But it does not include any additional funding that it is widely reported in the press that the President will be seeking for homeland security.

There is no provision here for a stimulus package; is that correct?

Mr. CRIPPEN. That is correct.

Chairman CONRAD. And there is no provision here for expiring tax provisions that we all know will be extended.

Mr. CRIPPEN. That is correct.

Chairman CONRAD. And there is no provision here for a farm bill over and above the so-called baseline.

Mr. CRIPPEN. No.

Chairman CONRAD. So in many ways, this is an optimistic forecast in terms of a projection of surpluses going forward.

Mr. CRIPPEN. Yes, sir. It may be optimistic relative to fiscal policy that you pursue; it may, frankly, be a little pessimistic on the economic side, but we will see that soon.

Chairman CONRAD. Can you remind us what your forecast was for the debt of the country last year, by the year 2008?

Mr. CRIPPEN. We said that by 2008, all available debt held by the public would be essentially paid off. There are some things, such as like savings bonds and a few other securities, that would not be, but most of the debt held by the public at that point would be paid off.

Chairman CONRAD. And what is the anticipation now in terms of the debt——

Mr. CRIPPEN. That result will not occur in this decade in our forecast. That is to say, if our projection is right, we will certainly be increasing debt held by the public for the next couple of years, and only then perhaps, depending upon, again, fiscal policy, starting to buy it back down. But clearly, we will not retire the available debt held by the public in this baseline in this decade.

Chairman CONRAD. And would it be fair to say that your numbers indicate that by 2008, the publicly held debt will be $2.8 trillion?

Mr. CRIPPEN. I am sure that is correct, yes.

Chairman CONRAD. In terms of your forecast for growth, maybe you could share with us what you are anticipating for this year in terms of economic growth, quarter by quarter?

Mr. CRIPPEN. I will look for the quarterly numbers—John probably has them here. We are anticipating that the recession, if it has not already reached its bottom, will certainly in this first quarter, and in the forecast, we are showing an essentially flat economy in the second quarter—this is real GDP now, not nominal—with growth of a couple of percent by the end of the year. So it is a fairly slow recovery, as I indicated in my opening remarks. We may already be in a recovery; we do not know for sure.

Chairman CONRAD. Thank you.

Senator Domenici.

Senator DOMENICI. I will come back to myself later and yield to Senator Grassley.

Senator GRASSLEY. I have forgotten—did you say we would have 5 minutes?

Chairman CONRAD. Seven minutes. We will go by what we have traditionally done.

Senator GRASSLEY. That is fine with me.

Before I ask questions, you had a very interesting chart up there, and we have a handout here, of the taxes as part of GDP from 1944 through 2012, and the average for those 70 years would be about 18 percent. And obviously, they go up and down, but except in war time, there is not too much variation until recently. Since 1992, they have been way above the 70-year average, and at the peak of our tax cut legislation last year, they had reached a point as high as they were in World War II. Then, for the next 10 years, the tax cut comes down. But even in light of the second-largest tax cut in the last 50 years, we are still going to have taxes as a percent of GDP much, much higher than they have been in that 70-year average. Your chart shows that, and I just want to highlight that, because we hear so much about the tax cut being responsible for where we are today in our fiscal projections and budget balance projections. On the other hand, even after that large tax cut, taxes are still higher than they were in that 70-year average.

The other thing that I would like to point out about the tax cut last year—we passed an approximately $1.3 trillion tax cut in a bipartisan vote. I think we had all but two Republicans, and I think we had 10 to 12 Democrats who voted for it, so it was very bipartisan. The last alternative offered by the other side was a tax cut of $1.265 trillion, or about 6 percent less.

I only point that figure out because the budget resolution for the Democrats had tax cut of $795 billion, but the one that got the most votes, 48 votes—at least 48 Democrats voted for it; I do not know if any of those 48 were Republicans, but if they were, it was one or two—so we have the vast majority, all except a handful of Senators out of 100, who have voted for tax cuts of at least $1.265 trillion and a bipartisan majority that voted for 6 percent more than that that was signed by the President.

So the bottom line is if we have any problems between the tax policies of the other party and our party, there is only 6 percent difference between them, and that 6 percent would be relatively insignificant talking about the 10-year projections. I just think I should lay that out on the table for the benefit of everybody so we know that there is not a lot of difference between Republicans and Democrats on that point of tax policy for the next 10 years.

My questions to you deal with more arcane things than that. We hear that a policy has to take into consideration—particularly our tax policies and fiscal policies—the impact on interest rates, particularly over the long term. So I would like to refer to a recent Washington Post editorial that stated: “Future tax cuts exert upward pressure on long-term interest rates.”

The Washington Post is not alone in its claims that tax cuts will increase the deficit and drive up interest rates. However, I note in your testimony today that “Despite the fact that the projected 10-year budget surplus is now $4 trillion less than projected last year, CBO’s projection of future interest rates on 10-year government bonds is either the same or lower than projected last year.”

Do you agree that given the overall size of our global financial markets, there is no reason to believe that the tax cuts that Congress passed last year will result in higher interest rates?

Mr. CRIPPEN. Senator Grassley, the financial markets are subject to the same supply and demand phenomena as other markets are, but I think it is important here, especially when we are talking about loan rates, to understand that there are lots of things that can affect them, in particular investors’ outlook for inflation.

I remember my first mortgage in Washington was at 14 percent. Debt issuance by the government wasn’t the motivating factor; it was that inflation was very high.

So there are lots of factors that can affect loan rates. As you have said, we now have worldwide capital markets. Other countries are unfortunately experiencing rather anemic growth as well, so there is surely not a shortage of capital.

I think it is also important to note, Senator, that in some of the popular writing, as you have just quoted, that is only a piece of the analysis. We do not do dynamic estimates of legislative changes, as you know—sometimes to your frustration. So to say that it affects long-term rates, whether right or wrong, ignores all the other potential effects of the same legislation. The tax bill of last year, for example—and we said this back in July—on net probably has a positive effect on the economy, albeit a small one. But there are other changes that you implemented at that time that could offset or more than offset any damage done by an increase in loan rates.

But ultimately, as you said, the facts seem to suggest that loan rates are about where they were a year ago, before the passage of this tax bill.

Now, no one has found—and we certainly have not cracked the code, either—a strong causal relationship between loan rates and the budget balance or lack of it.

Senator GRASSLEY. So the difference of an estimate of $4 trillion of budget surplus last year versus this year has not caused your agency to change their projections of interest rates. I thank you for that.

In the CBO's recent Report on Economic Stimulus, I would like to quote: "The bigger the chunk of their income that consumers are willing to spend instead of save, the more stimulus there will be. But households do not predictably spend a particular portion of extra income left in their hands. Their propensity to consume appears to vary with their income and for other reasons that are little understood." That is at page viii.

The report goes on to note that "In general, approaches with the greatest estimated stimulus are also the most uncertain in their effects." That is at page 26.

So my question is this. It seems to me that CBO is telling us that nobody really knows whether a given stimulus policy will produce the intended results. Given this uncertainty about short-term stimulus, wouldn't it be better to focus on what would be the best for the economy in the long run and try to pass that as quickly as possible?

Mr. CRIPPEN. I certainly cannot disagree with your conclusion, Senator. As I have said here and many times before, for many of the long-term problems, we need to keep our eyes focused on economic growth. Stimulus, as you have just recited from our own report, can be both in the eye of the be holder, and somewhat uncertain. It depends a lot upon whom it goes to, and it depends a lot upon what form it takes.

There are some studies that suggest that people respond differently if they get a lump-sum payments, as they did last year, as opposed to just having their paychecks increased. So there are different behavioral responses. The evidence is not very clear all the way around. We have a couple of theories, neither of which seems to match the data very well.

So your essential conclusion I cannot object to, but we did define in that report, as the Chairman asked us to, stimulus as being what would increase demand in the short run, not what would grow the economy in the long run, and those are two very different questions, as you suggest.

Senator GRASSLEY. Thank you, Dr. Crippen.

Chairman CONRAD. Senator Hollings.

Senator HOLLINGS. Now I get my chance.

Thank you, Mr. Chairman. Here we go again, as President Reagan said.

I do not see much difference between this kind of presentation and consideration of budget responsibilities and Arthur D. Andersen.

Mr. CRIPPEN. We did not shred any documents, Senator.

Senator HOLLINGS. Let us go right to the record. The record shows, for example, that the debt—I want to answer Senator Domenici. On page 17 of "The Budget and Economic Outlook" that you presented last year, Dr. Crippen, the debt goes up over $1 trillion, from $5.6 trillion to over $6.7 trillion. That wasp ut out in January, and the President comes on February 27 and says there are surpluses as far as the eye can see, surpluses, surpluses—when you have already reported that we are borrowing money, that the debt is going up. And I quote: "My plan plays down the unprecedented amount of our national debt and then, when money is still left over, my plan returns it to the people who earned it in the first place."

Then, the next week, the recession started. Whereas all we had to do was read what you said, that we were not having any surpluses. That is my resentment of this charade that goes on. We all say we are not spending Social Security, and we are not going to touch Medicare and so on, and then we use that euphemism of the public debt, the private debt, the government debt, on-budget, unified budget, and every other darn thing, as whether or not you spent more than you took in. And that is what we have been doing since Lyndon Johnson.

I have been trying my level best to speak one language, namely, trying to be fiscally responsible. Now, the distinguished ranking member says that what we have got to have as our priorities the counter-terrorism war and homeland security, and I agree with him—but we have got to pay for it. Where is the idea that we are going to pay for it by further tax cuts, running up the debt?

For years on end, we have been trying to pay down the debt, and this gamesmanship—you do not put the debt in this particular document that you have given us this morning; it only says the baseline surpluses. But I think there is an increase in the debt. I think CBO will put that out maybe next week, or something like that. In other words, in 2001, it goes from $5.772 trillion to $7.644 trillion. Isn't that correct, Dr. Crippen?

Mr. CRIPPEN. That's correct.

Senator HOLLINGS. So that is almost $2 trillion. Here we go. And on this page here—that is what is misleading, and that is why I say Arthur D. Andersen. This is what we who bought the stock, if you know what I mean—and I did not buy any, but let us say we who bought the stock—on page 7, you have baseline projections of surplus, when the truth of the matter is that we are projecting that the debt is going up, up, and away to the tune of almost $2 trillion. And then to talk about mistakes—my point is, most respectfully, Chairman Conrad, that it is not mistakes, mistakes, mistakes. All we had to do was read what the gentleman put down there in his budget report—and read it next week when they give it to us, because we only have half of the audit—this is the Andersen audit—here this morning, and it talks about surpluses when the truth of the matter, and Mr. Crippen has just testified, is that it is going up just about $2 trillion. And these 10 years—according to your document, $4 trillion in 1 year?

Then, on the debt limit, isn't it true, Dr. Crippen, that you projected that we would not have to increase the debt limit until 2009?

Mr. CRIPPEN. It was not quite that long, but it certainly was a year or two from now, not next month.

Senator HOLLINGS. On, no. It was 2009, you said in your document.

Mr. CRIPPEN. Was it? I know it was several years from now, because we anticipated paying down debt. But at the same time, as you point out, last year as well—other debt will be going up.

Senator HOLLINGS. We will have to get for you, because I have looked it up specifically. In any event, by December, they were asking us to sneak it into an appropriation bill so that we would not have to politically face the music here next month. In February, we are going to have to increase the debt limit—while all the time talking about let us get stimulus, and we are going to have tax cuts—that we do not have. And yes, Dr. Crippen, I want to do away with all the remaining so-called tax cut. I voted against it and tried to kill it last year. If we can do that, we can do just exactly what Governor Bush—he does not call it a "tax increase" when he deals his tax cut. Senator Domenici, you call it a "tax increase." I go along with Governor Bush, not President Bush, who calls it a "tax increase."

And then we read in the morning paper where a dozen Governors are going to have to increase taxes even in light of a recession, because they have got to maintain fiscal responsibility, and that is the primary responsibility of this Budget Committee. And we do not answer to that responsibility. We engage in the charade and call deficits surpluses.

On page 4 of the CBO testimony of Dr. Dan Crippen of January 23, 2002: "At that time, CBO also projected that the statutory ceiling on all Federal debt would not be reached until 2009." So there, we have congealed it, bam, right into it. That is how far off we are.

So unless we get serious about paying down the debt—I can see the Senator from Texas, who said, "When you raise taxes on Social Security, they are going to be hunting you down in the streets and shooting you like a dog." That is what he told me and——

Senator GRAMM. That was close, Fritz, but not exactly; I think it was "with dogs." [Laughter.]

Senator HOLLINGS. Oh, yes. And then we increased gas taxes, and we had an 8-year economic boom. Ever since we started on this thing after President Bush's election, that we are going to cut and give the people back their money, give the people back their money, surpluses as far as the eye could see, when as far as the eye could see, there was nothing but deficits.

That is my point in coming here this morning. I want to see if we can get some kind of sobriety and reality to these proceedings as a Budget Committee, because when we join in and the press joins in and uses the same dichotomy that it is surpluses instead of deficits, we are in trouble.

My time is up. Excuse me, Mr. Chairman.

Chairman CONRAD. That is fine.

Senator Gramm.

Senator GRAMM. Well, Mr. Chairman, the public finds what we do to be unrealistic because we sit here and say you did, you didn't, you did, you didn't, you did, you didn't, but when the public has disagreements, they go and look up the contract. When somebody goes to the grocery store and picks something up and goes to the checkout counter, they do not argue about what it costs; they go back to where you got it, and they look at what the price was.

It seems to me that a very instructive thing to do here is to go back to the contract. And I just want to make note that in the 1998 budget, this Congress on a bipartisan basis and the Clinton administration entered into a contract to balance the budget in 2002. That was the contract.

And if you look on pages 58 and 59 of that budget, and you compare it to the numbers in the projection you gave us today for 2002, it is very, very instructive, it seems to me.

The American taxpayer to balance the budget this year was supposed to put up $1,890,400,000,000. In fact, looking at your numbers, the actual number despite the tax cut turned out to be $1,983,000,000,000, so as compared to the contract to balance the budget, the taxpayer actually put up $93 billion more than we were counting on him to put up even with the tax cut.

If you look at your chart, I think the reason is that the tax burden even with the tax cut is very high by historic standards.

On the other hand, our part of the bargain in discretionary spending was that we were going to limit discretionary spending to no more than $561 billion this year. That is the 1998 budget agreement on page 59; that was going to produce the balanced budget.

What did it turn out to be in your projections? It turned out to be not $561 billion, but $733 billion. So we spent $172 billion more than we committed that we were going to spend to balance the budget when we entered into this agreement in the 1998 budget.

In fact—and I think it is very interesting—$127 billion of that $172 billion over overspending occurred before January 1, 2001. In other words, it occurred under the previous Congress and the previous President. If you remember, we had that spending orgy in the last 3 months of the last Congress.

So in regard to who did what and who is responsible, the point I want to make is that in this bipartisan agreement with the previous Administration, if you take it as the guideline—like going to look and see what the can of peaches cost where you picked it up, or what the contract was—it seems to me that our problem is overspending.

But here is the point that I want to make. Ultimately, many of our Democratic colleagues—and Senator Daschle is at the very top of the list—basically say that the tax cut is the embodiment of all evil in the country; it made the recession worse, and it produced all kinds of terrible problems. I think the problem with that approach is that ultimately, the American people are going to ask: Well, if it is so terrible, why don't you reverse it?

I might also say, to make this somewhat bipartisan, that Republicans cannot sit here and say that spending is the problem and then keep voting for all this spending.

Ultimately, it is not—and I have always, I think, consistently said this about the budget, and I believe it—what I have witnessed in my 24 years of dealing with the budget—and I have been involved in every budget for 24 years, and my mother once asked me if it bothered me that the deficit kept getting bigger, and I ran for Congress to get rid of it, and I always responded that, well, everybody knows what I am trying to do, and at one point, I actually thought we had gotten rid of it; it just did not last long.

But here is the point. If we are going to sit here, and the Democrats are going to say the problem is the tax cut, but we do not want to reverse it, and the Republicans are going to say the problem is spending, but we do not want to control it, what is going to happen? Nothing.

Ultimately in these budgets, it is not what the reality is that it seems to me is so important, it is what are we going to do about it. What are we going to do about it?

I would just like to say, Mr. Chairman, that we can go in one of two directions here. We can have a partisan approach, and you all can try to write a budget, and you might be successful in writing it; or we could sit down on a bipartisan basis and see if we can write a budget.

It seems to me that if we could do that, we would maximize the probability of one being adopted. I am very concerned that all of our spending constraint measures that we have put into place in the past that have given us all these budget points of order, which have not always been successful, but they have helped—they are all gone now. Unless we put them back into place, not only will we not have a fort to protect ourselves, we are not even going to have a good stone wall to our backs in a gun fight.

It seems to me that, hopefully, we might be able to reach an agreement to write a budget that puts some of these constraints back.

Let me also say that it is true that we are in a recession, it is true that we are in a war, but I would have to say that I still believe that there is a tremendous number of programs that we are funding that do not make sense in the modern context. As I looked at the defense appropriations bill, while there was much in it that I supported, there were many provisions in it that I thought had more to do with bailing out corporate America than they had to do with defending the country.

So I believe that we can improve our situation by controlling spending, but in the end, I do not think we are going to get anywhere by just simply saying the big problem is the tax cut—of course, we are not saying that it is the embodiment of all evil and has produced all of our problems—we are not saying we want to change it, of course. We just want you to know what the facts are.

And on our side, I think that if we are saying the problem is spending, we ought to be willing to do something about it.

I did not get to make an opening statement, Mr. Chairman, so I just took this time to do that.

Chairman CONRAD. I thank the Senator, and I welcome his observations with respect to measures on constraint. I do think that we as a committee have a special obligation now that we are back in deficit to review the whole question of those constraints that are going to end this year. I look forward to working with Members on both sides. I think it is going to be critically important that we get those constraints put back in place.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman, and welcome, Dr. Crippen.

I want to ask a couple of specific questions, and I have a statement for the record. I particularly want to thank you for pointing out that when you look at 2010 and beyond, you run right into that projected Federal spending on Social Security, Medicare, and Medicaid that is going to cause enormous constraints on our ability to make other choices. We are running roughshod into that box, and I think that is one of the reasons why there is so much emphasis on the tax cut. If we invade the Social Security Trust Fund and the Medicare Trust Fund now, we do not have the ability to deal with that.

I have a couple of specific questions. First of all, are your estimates on interest rates averages over the year—they must be. I am presuming when you say short-term 3-month Bill rates are 3.4 in 2001, that must be the average for the year.

Mr. CRIPPEN. The average for each quarter.

Senator CORZINE. Quarterly averages. Because as I recall, interest rates at this time a year ago in the short-term area where roughly 6.5 percent on the Federal funds rate, and I think they have come down 4.75 percent. And the whole debate about long-term interest rates having an impact on the economy and having impact on budget projections and interest costs is the fact that they have not moved, and short rates have declined 4.75 percent in that timeframe. So it is the shape of the curve that I think people are emphasizing as the basis for why long-term rates are looking, at least to some extent, whether it is inflation or the inflationary impact of borrowing in the market. I wonder if you have made an estimate of what the difference—I think you mentioned this; I know that Senator Conrad did—the expected debt at the end of the decade is $2.8 trillion as opposed to estimates last year of $600 billion; is that rightly right?

Mr. CRIPPEN. That's right—for debt held by the public.

Senator CORZINE. I would argue that for those who operate in the financial markets, $1 trillion tends to have some impact on people's expectations about where interest rates will be in the future, and I think that when we are looking at interest rates that have not moved in a year, that is a pretty dramatic statement in and of itself given that we have had a 4.75 percent decline in short rates at the same time. I think that is impacting back into these budget projections, and I think that is worrisome, because it both leaves us with less resources to spend on whatever it is—homeland defense, national defense, or a prescription drug benefit—and I think is a potentially serious cost.

If you have any comments on that, I would be curious.

Mr. CRIPPEN. As I mentioned earlier, Senator, there is not convincing, compelling evidence that we have found to link the budget deficits with interest rates. Clearly, there must be a supply demand phenomenon going on here, and if we are demanding more and selling more debt, that could have an impact. But there are lots of other things going on as well, not the least of which is the rest of the tax bill, which could have different offsetting effects.

What we are focused on, and what is part of your question, is what does the implied increase in debt do to interest rates? That is an important question, but not the only one. We do not do dynamic estimates of the tax changes or spending changes in part because there are so many of them. So to focus on just one factor, I would suggest, whether you are right or wrong, whether that is the correct phenomenon, is not the whole picture, anyway.

Senator CORZINE. I would agree that there are other things operating, including the strength of the economy at the time, but $1 trillion is something that generally, people factor in—it affects supply and demand.

Do you have productivity assumptions built in that I have not been able to see? One of the most controversial elements in projections of the budget surpluses a year ago was productivity assumptions that were outside the range of what was seen, at least except in the last 5 years of the 1990's. I did not see them in there.

Mr. CRIPPEN. They may not be in what you got today; they certainly will be in the January 31 publication.

Senator CORZINE. Do you know what those are offhand?

Mr. CRIPPEN. We reduced them again somewhat. I think we took total factor productivity (TFP) 0.2 percentage points.

Senator CORZINE. So it still would be large relative to other periods in the last 20 years.

Mr. CRIPPEN. Relative to the 1970's, certainly, but smaller than the previous five years.

Senator CORZINE. One thing that I think we can all agree on—that fan-shaped analysis that you talked about is a real issue that we need to understand when we sit down and hammer out whether it is tax cuts or spending cuts or however we put the budget together. There is a broad range of probabilities that we need to assign, and one of the chief issues of debate is this productivity assumption, and it makes big swings in where we are. So interest rates and productivity are things that I am certainly concerned about.

I understand that over the break, you did a review of some of the options on economic stimulus and recovery. I would like to know how you thought accelerating the marginal rate cuts that have been proposed would do with regard to short-term stimulus and the economy?

Mr. CRIPPEN. As I recall, we concluded that relative to its costs, it would not do a lot to increase demand in the short run.

Senator CORZINE. And were there particular initiatives that you thought would increase short-term demand?

Mr. CRIPPEN. The things in particular that put money into taxpayers' hands quickly. As I suggested earlier, the form of that can be important, too, whether it occurs in a lump sum, which does not appear to be consumed as quickly, at least, and probably not as much, or if it appears in payroll checks, where it has a higher tendency to be consumed.

Senator CORZINE. So, Senator Domenici's proposal with regard to a payroll tax holiday has a higher incentive?

Mr. CRIPPEN. Yes.

Senator CORZINE. Finally—and this is the hardest of these, and you will probably want to duck it, but I will ask it anyway—do you have a view on the question of whether a tax cut that is not implemented is a tax hike?

Mr. CRIPPEN. Well, I will duck it only a little in that it is kind of an existential question.

Senator CORZINE. But real for some of us with beards.

Mr. CRIPPEN. I understand. We have lots of things like this in the budget world—is a reduction in the increase in spending a cut or an increase—and we do a lot of dancing on the heads of pins.

I can say that the rules that govern what we do and how we score things would clearly show a delay or an elimination as a tax increase or revenue increase, because our baseline assumes current law, and current law has the further reductions embodied in it.

So for scoring purposes, I can tell you that we would show it as a revenue increase.

Senator CORZINE. Thank you.

[The opening statement of Senator Corzine follows:]

OPENING STATEMENT OF SENATOR JON S. CORZINE

Thank you, Mr. Chairman, and welcome, Director Crippen.

I personally want to thank you and your staff for your cooperation. I particularly appreciate your willingness to present an analysis that presents some bad news rather clearly—that last year's tax cut has put us on a path that will use Social Security funds over the next 10 years, and beyond.

Mr. Chairman, CBO's new report verifies what many of us have been suggesting for some time: the Federal Government's long run fiscal condition is much weaker than we thought last year, when we passed huge new tax cuts.

Now we face the prospect of deficits for several years, with a significant invasion of Social Security and Medicare Trust Funds. And that's before we even consider new funding for national security, homeland security, prescription drugs and other legislative priorities, or an immediate economic recovery program that I believe all of us support.

Mr. Chairman, throughout last year's tax debate, you and many of us sounded the alarm about the questionable assumptions underlying the tax cut. We said that 10-year forecasts were inherently uncertain. We said they failed to account for unforeseen security threats and other inevitable emergencies. We questioned the rosy productivity scenarios. And we pointed out that official baselines hid many other known costs and future liabilities.

Unfortunately, these warnings were ignored or deflected by best case expectations. And now the chickens are coming home to roost, or at least they are standing on our doorstep.

The world is a very different place than when Director Crippen came before us last year. We have a war on terrorism to fund. We need to beef up security here at home. Our economy is in recession. And the health care crisis is only getting worse.

Mr. Chairman, a changed world means that our fiscal policy should change, as well. It's now clear that we simply cannot afford all of the huge tax breaks for high income individuals in last year's tax bill. If we don t revisit some of them, it is inevitable that we will both raid the Social Security Trust Fund now and into the future, but we will fail to provide a meaningful prescription drug benefit. We won't have the resources.

Does that mean we should raise taxes in the middle of a recession? Absolutely not.

Does it mean that we should raise one penny of taxes from struggling middle class families? Absolutely not.

But does it mean that people with incomes over, say, $140,000 may have to wait before getting more tax cuts in the future? Yes. Frankly, the choice is between that and raiding Social Security. There's just no way around it.

Mr. Chairman, based on recen headlines, for years, the Enron Corporation used phony accounting to hide the truth. In the past year, unfortunately, we've seen the Enronization of the Federal Government. If we don't confront the truth about our fiscal condition, and change course, the long term consequences could be similarly disastrous.

With that, I look forward to hearing from Director Crippen and working with you and all my colleagues in the year ahead.

Chairman CONRAD. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Dr. Crippen, thank you. I do not often have the opportunity to listen to existential conversation.

Mr. CRIPPEN. We will get to metaphysical next.

Senator HAGEL. I will have to leave—but thank you for appearing. Your input is, as you know, very important.

One of the points that you made as you presented to this committee projections for outyear spending on Social Security, Medicare, and Medicaid, that Senator Corzine was referring and others have referred to, is something that we have all been mindful of—sobering numbers. If I recall, a point that you made was that it is not just important that you maintain the trust funds, but the real issue is how do you grow the economy. Is that generally a correct paraphrasing of what you said?

Mr. CRIPPEN. Yes.

Senator HAGEL. And with that as kind of our baseline here, I would like to start where you left off with Senator Corzine on scoring tax cuts. It is my understanding that the Joint Committee on Taxation does most of that; they are looking for ways that might make more sense to improve the macroeconomic dynamic of tax cut scoring. I think you take into consideration some of the behavioral patterns that you can track through various sources.

The first question about that is do you think it is important that your committee would eventually get to a dynamic scoring model to include the benefits of tax cuts—if there are any—to the economy? For example, you mentioned growing the economy. Is it important, as you responded to Senator Corzine about productivity, to factor in investment spending? Does that affect productivity? Does that affect economic growth? Does that then affect tax revenue? I am a bit biased because I think it does.

Could you take us through that a little bit and explain what you are doing and what you are not doing? Are we losing something here by a static analysis of tax cuts? I think history is rather complete if you look at the last three rather sizable tax cuts, and in fact it has generated significant new tax revenues. I go back to the Mellon tax cuts from 1921 or 1929, I think, generally in that area.

I would be very interested in your thoughts about this.

Mr. CRIPPEN. Senator, currently, of course, as you already said, we do not generate the revenue estimates of changes in law; that is the Joint Committee's purview. On the other hand, it is not entirely their responsibility to assume fully dynamic estimates, because we would have to change our baseline if there were to be such an incorporation. And we have certainly been talking to them about what they see as compelling evidence one way or the other on certain tax effects.

Having said that, though, we currently include in our harding assumptions what we anticipate the economy will be like over the next 10 years, and that would include any effect of tax revenues, up or down. In that sense, we incorporate legislation as we know it when it comes time to do the baseline.

So there is a macro dynamic included in our baseline, and that is for current law. Now, if you propose further tax changes this year, we would not feed those back into our baseline and would not get a revenue estimate that is dynamic in the way that you are discussing.

We tend to agree that there are some macrofeedbacks. As Senator Corzine was saying, it is possible that there is an increase in long-term interest rates involved here. We do not have compelling evidence for that, and we do not include it in the baseline at this point. And there are other things in the tax bill that would perhaps help economic growth.

So the net of it is, we have a sense of—and the economics profession has some conclusion about—the direction of change with some particular types of taxes that will help or hurt, for example, economic growth or the labor supply or some other aspects; but we do not have any conclusion as a profession about the magnitude. So if we have offsetting effects, as we do in many cases, because it is not just a rate cut bill, and it is not just a rebate bill, it is hard to say on balance where it comes out.

We do try, however, after the fact to qualitatively give you an assessment of what macroeconomics, at least as we currently practice it, would suggest. We did that in August as a qualitative statement about how the tax cut—the tax bill at that time—is likely to help economic growth in the long run, but probably by small amounts, in part because in truth, the annual amounts of the tax reduction are small relative to the size of the economy.

Senator HAGEL. Do you think generally that you can make any fair assessment one way or the other that tax cuts help economic growth or assist the economy in any way?

Mr. CRIPPEN. No. In general, the profession would say that certain kinds of tax cuts like marginal cuts——

Senator HAGEL. What we passed last year.

Mr. CRIPPEN. Some of that would, yes. As I said, there is a qualitative assessment that has been very public, that we put in our August update, talking about the various pieces of the tax bill and the kinds of effects they would have on the economy. But again, as you started out with and I concluded with, what we need to keep our eye on in most of these discussions is what effect do those things, whatever they are, have on the growth of the economy. Ultimately, it is the economy that is the trust funds. It is our kids who will be paying us, so the way we can help them is by growing the economy.

Senator HAGEL. One final question, since I think I have a minute left—or maybe not.

The $40 billion that we passed last year in emergency supplemental spending after September 11—as you recall, we put $20 billion of that in fiscal year 2001 and the other $20 billion in fiscal year 2002—how has that been scored?

Mr. CRIPPEN. The $20 billion that is in fiscal year 2001 would not be extended in our baseline, because it was not for the current fiscal year, in effect. The rules tell us we have to include what is in 2002 and inflate it for the future. So the second $20 billion is included in the baseline as $20 billion, and then it gets inflated.

Senator HAGEL. Where is that in your budget? Where is that located, under what——

Mr. CRIPPEN. It is split among the various agencies that received the appropriations. Only about $2.8 billion, as I recall, went to defense: the rest of it was split among domestic agencies of FEMA and HHS for bioterrorism and other things. So it was spread out across the budget, and we have a breakdown of that if you would like it, but that is where it shows up in the agencies.

Senator HAGEL. Dr. Crippen, thank you.

Mr. Chairman, thank you.

Chairman CONRAD. Thank you, Senator Hagel.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, for holding this, what I believe is a most important meeting that will set the stage for the entire year and, frankly, the decade into the future, and thank you to Dr. Crippen as well.

I would like to step back and speak from a big picture standpoint. I agree with our esteemed ranking member, who certainly is an expert on budget matters, that when we look at our priorities right now, safety and security, the war on terrorism, homeland security certainly top our agenda; the economy, jobs, making sure that people are able to care for their families and make a living and create businesses and so on certainly top the agenda.

When I listened to Dr. Crippen talk about the fact that within 10 years, on the course that we are headed, we will be looking at massive tax increases or debt or cuts which would include, I assume, defense and homeland security and education and other areas, if we do not deal with what is happening right now. So we have top priorities that we agree on, and we know that we are on a collision course in terms of the budget if we continue to use Social Security and Medicare funds, and yet we have not at this point been willing to look at all the decisions we have made in the last year and the impact that they have.

I believe very strongly that it is irresponsible for us to move forward and not review decisions that we made last year concerning the phase-in of tax cuts which, frankly, Mr. Chairman, we all know that once we got beyond the $300, are very much geared to the top 1 or 2 percent of the public—the wealthiest Americans.

Senator Hollings spoke about Arthur Andersen, and I want to make a comparison to Enron, not because they are connected at all. But in my home State of Michigan, there is a real feeling that this is a lot like Enron, where the folks at the top take their money out and leave the middle class taxpayers paying for it through their retirement funds and loss of 401(k).

I would argue that what we have been told today is very much like that. The top one or 2 percent of the public will get major tax cuts, paid for by the retirement earnings of Social Security and Medicare by the majority of Americans. I believe that that is wrong, Mr. Chairman, and we need to reconsider and rethink that decision.

I would urge us in that process to go back to something that Senator Snowe and Senator Bayh and I spoke about last year, which I believe we should have put in place, and it is not too late to do, and that is some kind of framework or budget trigger where we do not proceed with either a phase-in of tax cuts on spending if it dips into Social Security and Medicare.

I would like to share with you what is happening in Michigan right now to demonstrate that this is not a partisan issue. We have a well-known Republican Governor, John Engler, and the cornerstone of his Administration has been tax cuts. The House and Senate of Michigan are a majority Republican. Yet when they put in place a 10-year phase-in of the elimination of the single business tax a couple of years ago, they put a budget trigger on that. They said that if the rainy day fund or the surplus of the State dipped below a certain amount, $250 million, they would suspend the next phase-in of the cut until they could pay for it without the State of Michigan going back into deficit.

This year, they are having to suspend that phase-in, that next step, as I understand it, in order to avoid going back into debt. I would argue that that is a good lesson for those of us here who care desperately about fiscal responsibility and keeping the budget balanced and, most important, protecting Social Security and Medicare.

I would very much hope that in this debate, Mr. Chairman, we would have the opportunity to once again debate this framework of a trigger that puts in place the values of doing all we can to protect Medicare and Social Security and maintain fiscal responsibility as we move forward.

Dr. Crippen, I do have a question for you that relates to your numbers. You have indicated that your 2003 to 2012 unified surplus projection is about $2.2 trillion, as I understand.

Mr. CRIPPEN. Yes.

Senator STABENOW. However, you also stated in your testimony that this projection includes the gimmick that was passed last year in the tax bill, where all of the provisions of the tax cut sunset in 10 years.

Could you speak to what ultimately happens if the sunset is eliminated and the tax provisions continue, and what that would do to our overall fiscal situation?

Mr. CRIPPEN. It would worsen it in the context that you are discussing by several hundred billion dollars; that is, if the tax changes are extended beyond their current expiration, surpluses would be smaller, and there would probably be no on-budget surpluses in 2011. So it would increase the amount of debt, and it would reduce the surpluses.

Senator STABENOW. So if we are having difficulty now just suspending the next steps in order to protect Social Security and Medicare, my assumption is that it would be difficult 10 years from now in order to see those sunsets take place. So I think it is important for us to also see in the context of the concerns about Medicare and Medicaid and Social Security—they become, I believe you just said, several hundred billion dollars worse if the tax policies are extended beyond the 10-year period. I would hope that we would consider that as part of the discussion as well, Mr. Chairman.

Thank you.

Chairman CONRAD. Senator Allard.

Senator ALLARD. Mr. Chairman, thank you very much, and Dr. Crippen, I appreciate your coming to talk to us at the committee today.

I do want to talk a little bit about tax cuts, but I would like to make a point before we get too far. Whenever we get to talking about putting some kind of trigger in the budget, we always want to apply it to taxes, and we do not want to apply it to spending. It seems to me that there needs to be some balance in there if we are going to take the trigger approach, and I think that we certainly need to look closely at triggers on spending as well as triggers on tax cuts.

There is a theory that some economists espouse, and I would like to hear you comment on, called the Laffer Curve. I do not think anybody on this committee has talked much about the Laffer Curve recently. It says that if you have 100 percent of income taxed, you do not expect any revenue to come in to the Federal Government because people would not have any incentive to work; they would not earn anything. If you did not tax anything at all, there would not be any income in government because you were not collecting taxes. But there was a bell curve that somewhere in between, you could reach a point on that curve where you had maximum revenue coming to the government, and if you stepped over that, it would reduce, and if you went down on the other side, you would not have the maximum amount of revenue that you would expect to come in to the government coffers.

As the Chairman of the Finance Committee has said, taxes are at one of the highest points in the history of this country as far as gross domestic product is concerned. I cannot help but think that we are toward the top of that curve somewhere, and maybe even around the year 2000, looking at the charge, it looks like it is the highest it has been since World War II.

Would you comment a little bit about where you think we might be on that curve, and maybe how you feel about that approach?

Mr. CRIPPEN. I think your setup of the Laffer Curve is absolutely true. Both extremes would give you zero revenue. But I do not know, frankly, and I am not sure our profession knows, a lot more about what the shape of that curve is or how it is constructed. That is, I do not know where we are currently on it, at it, or beside it.

Senator ALLARD. Do you think it would be a helpful tool?

Mr. CRIPPEN. Well, if we knew with some certainty, sure, it would be useful. My guess is that although the research has been done, it has not really been able to nail it down. We have some general—some might call them platitudes—but general truths, if you will, that if you tax something, you will probably get less of it, so there is a diminishing return at some point on taxing labor or capital. On the other hand, there are collective needs of the government, so the appropriate level of revenue can be determined perhaps more by the needs of the government than a particular position on the Laffer Curve.

So there are all of these trade-offs, but the short answer to your question is that I do not know.

Senator ALLARD. OK. If we have spending at a high level, tax rates at a high level, it seems to me, to followup on your comment that we have two taxes, that if taxes get too high, it could have a depressing effect on government; but the inverse would also be true—you could also cut taxes and then stimulate the government. Would you admit that that could happen?

Mr. CRIPPEN. Sure, it could.

Senator ALLARD. Capital gains has a record, for example—during the Kennedy administration, President Kennedy proposed dropping capital gains, the Congress did it, and it increased revenue for him to have more spending. That happened during the Reagan administration, and it happened recently—when capital gains went from 28 to 20 percent, there was about $60 billion in unexpected revenues that was not accounted for—and I think at that time, it was just a straight line. I do not think in any of the projections that anybody was trying to project that it would have that positive impact.

I am wondering, during these times when we need an economic stimulus, if you would view a drop in capital gains as one of the most beneficial things that we could do to stimulate the economy.

Mr. CRIPPEN. Given this recession, it is a more interesting proposition than it might have been—that is, that this recession seemed to be precipitated by a falloff in capital investment more than a lack of consumption, although consumption did slow.

So if you were to change the taxation of capital writ large—and I will not speak just to capital gains, but to changing the taxation of capital—you might in fact get companies to invest. There were some proposals discussed last year about an investment tax credit, which we have not had for a while, which, if it were applied to only new purchases, might tip some companies into making capital purchases that they would not have before.

But all of it is on the margin, and marginal impacts, of course, are important for economists, but even with an investment tax credit of 5 percent or 10 percent, that capital still has to produce a profit for that company in the future. The tipping point of what would induce an investment is not clear. This does not help you a lot—but in general, if you reduce the taxation of capital gains, you make capital cheaper, and there will be an incentive to use more of it. And the reduced demand for capital was the principal cause of this recession.

Senator ALLARD. I brought up the issue of capital gains, and I appreciate your response on that. You also mentioned the investment tax credit, and I agree with you; I think there is perhaps an advantage there to help get our economy going. Can you think of any other tax reductions we could do that would have a stimulatory effect during a time of recession?

Mr. CRIPPEN. Well, it depends, Senator, too, on what you believe we need. As our response to Chairman Conrad over the break said, if you are trying to stimulate consumption, which may be the predicate needed to get companies to invest again, you need to put money into consumers' hands, and you need to do it quickly, and probably some ways are better than others.

If you are looking to stimulate long-term economic growth as opposed to getting us out of the current recession, then you may have a whole different set of tax tools.

And as you just suggested, lowering the taxes on capital may induce some companies who are close to investing anyway but have not yet done so, to do it.

All of those could be helpful. As we know, there can be countereffects, but in the main, if you want to stimulate consumption, give money to consumers; if you want to stimulate capital, obviously, you reduce the taxes on new capital investment.

Chairman CONRAD. The Senator's time has expired.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Feingold.

Senator FEINGOLD. Thank you, Mr. Chairman.

It is good to be back, although this hearing is a little depressing when you look at these numbers. It is not reassuring at all. The outlook for the budget both in the short term and over the next 10 years is troubling.

You pointed out in your presentation, Mr. Chairman, what a contrast this is to a year ago when, even as late as last May, CBO was projecting a unified budget surplus totaling $5.6 trillion over the next 10 years.

And as we know, those of us who have been on the committee for a while, this committee holds this hearing about this time every year, and we get CBO's best guess as to the state of the budget and the economy over the next several years. And CBO is very careful to point out that the projections are only guesses, as educated as they may be, and that as such, they could be off and that they could be off by a lot. And I want to thank you, Director Crippen and others, for indicating that caution.

In fact, in the past, the CBO has devoted an entire chapter in their budget outlook document to this very issue of uncertainty, and I have joked on occasion that maybe we should move it up to the front of the book, and now this seems a little more serious, just how dramatically important it is.

This uncertainty obviously should not paralyze us. I have no doubt that we are getting the best estimates possible. But if nothing else, our experience of the past year should teach us that the policy course we choose should reflect the uncertain that is inherent in the CBO's budget projections and that when we craft a budget based on those projections, we should do so with humility.

The President has used the word "humility" very effectively in other contexts. But last year, the President and the Congress did not treat those projections with humility. The policies enacted pursuant to that budget did not reflect the uncertainty of the projections, and as a result, we have an enormous budget hole to fill for years to come.

I also want to compliment Senator Gramm's point about the expiring points of order. He is absolutely right. They are not a substitute for making tough decisions about which programs to cut, but they certainly help us to sustain any fiscal discipline we can achieve, and we need to extend them in some form.

I came here in 1992, hoping to just get the deficit down, and I think those budget rules helped us go beyond that and actually get rid of it for a brief moment. We simply cannot be credible with the American people if we do not have those kinds of rules in effect.

Let me ask two quick questions, and this one has already been asked in some other ways by both Senator Grassley and Senator Corzine. In a speech on January 11, Federal Chairman Greenspan said, "Some of the firmness of long-term interest rates probably is the consequence of the fall of projected budget surpluses and the implied less rapid paydowns of Treasury debt."

Do you agree with Chairman Greenspan that interest rates are probably higher than they otherwise would be because the government has returned to running budget deficits?

Mr. CRIPPEN. Yes, with one caveat, and that is that the sentence, as I recall, that Chairman Greenspan uttered before the one you cited was that much of the run-up in loan rates can be attributed to the better economic outlook. So it certainly can be a factor. Again I would suggest that that would be an incomplete analysis—and I do not mean to chide the Chairman, but you will have him tomorrow, and he can get even—but that would be an incomplete analysis of the effects of the change in the budget outlook, and it could be positive or negative, but that one aspect alone does not tell you the whole story.

Senator FEINGOLD. Fair enough.

In a report issued earlier this month, CBO said in part that "Payroll tax holidays are likely to have the greatest bang for the buck of the proposals assessed in this report. Advancing the cuts in marginal income tax rates would have a relatively small bang for the buck because of the options cost, and repeal of the corporate alternative minimum tax would be least likely to generate significant stimulus."

First, do you stand by those conclusions?

Mr. CRIPPEN. Yes.

Senator FEINGOLD. OK. Then, based on this analysis, would we not expect to get the greatest bang for the buck, as your report put it, out of proposals like the one made by Majority Leader Daschle on January 4 and the one that former Chairman Domenici made last year that would cut the payroll tax, and that we would not expect to get a relatively small bang for the buck out of proposals like that passed by the House of Representatives on the last day of last year's session, which would advance marginal income tax rates and reduce the corporate alternative minimum tax?

Mr. CRIPPEN. I will leave those characterizations on the record the way you have stated them. It is certainly true, we believe, that if your point is to increase and stimulate consumption, then something like the payroll tax holiday, which puts cash into people's hands and does it in a way in their paychecks that we think will actually induce them to spend more than they would otherwise, is probably the best use of a stimulus dollar.

The elimination of the corporate alternative minimum tax is probably the worst, because in many ways it is just changing the taxation of capital already in place; it may be meritorious on other grounds, but certainly not as a stimulus matter.

Senator FEINGOLD. And how do you rank the marginal income tax rate cuts as opposed to the payroll tax holiday?

Mr. CRIPPEN. The same way we in our report; it would be lower in terms of bang-for-the buck, not nearly as good as the payroll tax holiday.

Senator FEINGOLD. Thank you, Dr. Crippen.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman.

As we begin this new year, I hope that somehow we can reconcile our differences and produce a bipartisan budget resolution. I could not help but think as well of the old cliche—what a difference a year makes. When we look back at the CBO report of last year, Dr. Crippen, that report indicated that "The slowing economic data do not as yet constitute a strong reason to expect a recession."

We know that the world is of course radically different from that time a year ago, and certainly an already faltering economy was exacerbated by the devastating attack on September 11. And I think the question is where do we go from here, and I think, like Senator Stabenow, with whom I worked on the trigger, that it is a policy mechanism that I do think is prudent and practical, and I think it is one that we should revive as we consider the budget this year.

Obviously, as Senator Stabenow indicated, the State of Michigan has introduced a trigger mechanism; the State of Maine has done that on occasions. It is a great way of controlling events that you otherwise cannot control because it is very difficult to forecast and to foresee some of the events and circumstances that might be created.

So I hope that we can look at that issue once again on a bipartisan basis—and it did include not only tax cuts, but it also included spending, because as Senator Gramm rightfully pointed out, he referred to the year 2000 and the changes that we made in policy that had an impact over 10 years of an additional $561 billion in increased spending. If you look at the 3-year total of changes in spending, it amounted to an additional $1.24 trillion in additional spending that had an impact over the next 10 years. So that clearly, spending as well has to be entered into the equation to see exactly what has occurred with the surplus.

Dr. Crippen, I was interested in your economic forecast and your projections for economic growth, because I think that clearly, our goal has to be maximizing economic growth. I noticed that in the year 2003, you actually project higher economic growth than in the original forecast of January 2001, higher between the years 2004 and 2007 than the projection of this last year, and the same between the years 2008 and 2011. Are you suggesting, then, that what is affecting our surpluses is in the year 2002 and 2003 alone?

Mr. CRIPPEN. No, Senator. Our forecast, which you just cited, is clearly relative to last January. Growth is much weaker now, negative in parts of last year, at least. And the 2003 that you cite is a bounce-back, if you will, from being well below what our normal growth would be. With inventory accumulation and other things, we forecast that we will get the 4.7 percent or so growth in GDP that I think we suggested for next year.

But the 10-year average is still lower than we forecast last January by several tenths of a percentage points, on average, so we are at a rate of about 3 percent total real growth. But the heart of your question, I think, is whether this is just a problem for the next year or two. In fact, the changes in economics have an effect over the longer term, both the changes themselves—we are starting from a lower base—and the revised data, which says we have less capital than we thought we did before, which would reduce growth as well. So we have taken growth down over the period as well as the revenues produced from that economy.

I do not know if I have been responsive.

Senator SNOWE. I am interested because the report indicates that you expect economic growth to be roughly the same as was projected last January over the 2002–2011 period on an average. So what exactly would—is it the year 2002 and 2003 economic growth projections that are having the significant impact of a loss of 71 percent of the surplus over 10 years?

Mr. CRIPPEN. No. Certainly, the economy is the single biggest factor for the next two or three years. After that, the legislation, for tax cuts and revenue cuts and spending increases, starts to predominate as the single biggest factor. But the change in economics which accounts for some 40 percent of the $4 trillion reduction in the surplus, some of its effects are spread out over the entire period. Economic and technical revisions, taken together, amont to 40 percent of the $4 trillion revision. Many of the revisions labeled "technical" have an economic source.

Senator SNOWE. Doesn't that provide a rationale for a stimulus package, I mean, to try to turn around the short-term nature of this economy? Irrespective of the fact that technically, we may emerge from a recession, the question is what type of recovery, and that could have a predominant influence on economic growth. If we have a jobless recovery that is similar to 1991, clearly, people are not going to feel that they have emerged from a recession, but it is also going to have an impact on our revenue picture as well.

So wouldn't a stimulus package of some kind that could clearly influence the short-term behavior of this economy make a pronounced difference in the short-term projections and ultimately the bottom line?

Mr. CRIPPEN. If it could make a difference in economic growth, then yes, it would make a big difference to the bottom line. It is the weakness in the next year or two that could contribute substantially, particularly in the short run, to the change in our outlook.

Senator SNOWE. And you mentioned in the CBO Outlook of last year that a 0.1 percent change in growth can clearly have an impact on the surplus of $244 billion over 10 years. Is that pretty much true today?

Mr. CRIPPEN. Right. I think we stayed close to that number. It is in Appendix A. It will be in the first appendix of the report that will be published next week, but yes, it is about the same.

Senator SNOWE. So that obviously, our focus should be on changing those economic growth numbers this year and next particularly; would you agree with that?

Mr. CRIPPEN. I agree absolutely, wholeheartedly.

Senator SNOWE. OK. I appreciate it, Dr. Crippen. Thank you very much.

Chairman CONRAD. Senator Clinton.

Senator CLINTON. Thank you very much, Mr. Chairman, and thank you, Dr. Crippen.

I am sorry that Senator Gramm has left. I thought that his, what I inferred to be an offer to repeal the tax cut and put new restrictions on spending sounded like a good place to begin, because basically, what I heard him saying was that we need to act on both sides of the ledger, which I think many of us around this table agree with. So perhaps, Mr. Chairman, we have the start of an agreement that we can work out.

Also, I think the points made by both Senators Stabenow and Snowe need to be revisited, and I certainly, as someone who supported their work on the trigger, would believe that it should be on both sides—that there should be triggers on spending as well as on tax cuts. That is the way many States have to operate. That is, to reiterate Senator Hollings' point, why Governor Bush is having to postpone tax cuts, because you cannot run those sorts of deficits at the State level. I have long thought that we ought to be looking at similar mechanisms, understanding the more difficult challenges facing the Federal budget, but I still think there is some wisdom in the State that we ought to try to learn from.

I have a couple of questions, Dr. Crippen, and I thank you for your testimony and for the work that you and your staff have been doing. But clearly, it is pretty breathtaking that in less than a year, $4 trillion of the projected surplus has disappeared. I do not think we should lose sight of the fact, as we go back and forth in our discussion, that that is really what you are talking about today. If you were to write a headline, it would be "Four Trillion is Gone" from the time that you sat here a year ago and made the projections with the very fair assessment of uncertainty that you put into those projections, but nevertheless $4 trillion is gone.

Your caution about what that means for us not just in the short term but in the longer term is one that we disregard at our peril. It is something that really haunts me that we would be putting this load of debt and these extremely difficult political decisions on the backs of our children instead of facing up to them ourselves.

I do not know whether Senator Gramm's idea of postponing tax cuts or even repealing them, along with stricter spending limits, following in the footsteps of both Senators Snowe and Stabenow will be heeded, but I certainly intend to do everything I can to make that case.

I would appreciate, Dr. Crippen, getting the tax rates on your chart, "Total Revenues as Share of GDP." Several members have made the point that the average of approximately 18 percent has been exceeded, but what I am interested in is that my recollection of tax policy going back 30 or 40 years is that the relative burden borne by different segments of our society has shifted dramatically. I would like to get that information if I could, because I think that the corporate tax rate and the individual tax rates on the upper end have gone down dramatically, and in fact, middle-income and lower-income Americans are bearing a disproportionately higher share of the tax burden, and this revenue spike is due in large measure to that increased share. Particularly when my constituents pick up the newspaper and see that a company like Enron has paid no taxers whatsoever, that was not the case in the 1950's and 1960's when corporate tax rates were both higher and tax collection was more strenuous.

[The following was subsequently submitted for the record by Mr. Crippen:]

In response to Senators Clinton's request for data on the relative tax burden borne by different segments of society over recent decades, we enclose Table G-1a from a recent study, "*Effective Federal Tax Rates, 1979-1997*" (October 2001). The study contains more detailed data on the distribution of effective tax rates and incomes, and it includes a discussion of methodological issues and a presentation of alternative measures.

Table G-1a.
Effective Federal Tax Rates for All Households, by Income Quintile, Using Comprehensive Household Income Adjusted for Household Size, 1979-1997 (In percent)

										1997	
Income Category[a]	1979	1981	1983	1985	1987	1989	1991	1993	1995	Under 1997 Law	Under 2000 Law
					Total Effective Federal Tax Rate						
Lowest Quintile	8.1	8.3	8.1	9.7	8.9	8.5	7.9	7.6	6.0	5.6	5.3
Second Quintile	14.0	14.2	13.0	14.5	14.3	14.3	14.2	13.5	13.6	13.9	12.8
Middle Quintile	18.2	18.7	17.1	17.7	17.3	17.6	17.3	17.3	17.6	17.5	16.7
Fourth Quintile	21.2	21.9	19.9	20.2	20.0	20.3	20.2	20.4	20.8	20.5	20.0
Highest Quintile	27.8	27.1	23.7	23.7	25.4	25.1	25.2	26.8	28.3	27.7	27.4
All Quintiles	22.3	22.4	20.2	20.6	21.3	21.3	21.1	22.0	22.9	22.8	22.3
Top 10 Percent	30.0	28.4	24.7	24.4	26.8	26.2	26.3	28.5	30.4	29.4	29.1
Top 5 Percent	32.2	29.6	25.3	24.9	27.9	27.0	27.3	30.1	32.3	30.9	30.5
Top 1 Percent	37.3	31.8	26.8	26.0	29.9	28.2	28.9	33.3	36.4	33.3	32.7
					Effective Individual Income Tax Rate						
Lowest Quintile	-0.4	0.3	-0.1	0.3	-0.7	-1.1	-1.9	-2.3	-4.5	-5.0	-5.3
Second Quintile	3.9	4.5	3.5	3.9	3.4	3.5	3.1	2.4	2.2	2.4	1.3
Middle Quintile	7.3	8.0	6.6	6.5	5.8	6.1	5.9	5.5	5.5	5.6	4.8
Fourth Quintile	10.1	11.0	9.1	8.9	8.2	8.4	8.2	8.0	8.0	8.1	7.5
Highest Quintile	15.9	16.7	14.1	13.8	14.6	14.4	14.1	14.7	15.5	16.1	15.8
All Quintiles	11.1	12.0	10.2	10.1	10.2	10.2	9.8	10.0	10.4	11.0	10.5
Top 10 Percent	17.7	18.3	15.5	15.2	16.4	16.0	15.7	16.7	17.6	18.1	17.8
Top 5 Percent	19.4	19.7	16.8	16.4	18.1	17.4	17.1	18.6	19.6	20.0	19.5
Top 1 Percent	22.4	22.0	19.1	18.5	20.7	19.5	19.7	22.5	23.4	23.0	22.3
					Effective Social Insurance Tax Rate						
Lowest Quintile	5.3	5.8	5.8	6.5	6.6	7.2	7.0	6.8	7.2	7.4	7.4
Second Quintile	7.3	7.8	7.6	8.4	8.6	8.7	9.0	8.8	8.8	9.2	9.2
Middle Quintile	8.3	8.9	8.7	9.2	9.1	9.4	9.3	9.5	9.6	9.7	9.7
Fourth Quintile	8.4	9.0	8.9	9.4	9.5	9.7	9.9	10.2	10.3	10.2	10.2
Highest Quintile	5.6	6.2	6.3	6.5	6.6	6.7	7.4	7.5	7.5	6.7	6.7
All Quintiles	6.8	7.5	7.4	7.8	7.9	8.0	8.4	8.5	8.6	8.1	8.1
Top 10 Percent	4.5	5.1	5.2	5.2	5.4	5.4	6.3	6.2	6.4	5.4	5.4
Top 5 Percent	3.2	3.8	3.8	3.8	4.1	3.9	5.0	4.8	5.1	4.2	4.2
Top 1 Percent	1.4	1.6	1.6	1.5	1.7	1.5	2.2	2.0	2.7	2.1	2.1

SOURCE: Congressional Budget Office.

NOTES: Effective tax rates are calculated by dividing tax liabilities by adjusted comprehensive household income.

A household consists of the people who share a housing unit, regardless of the relationships among them.

Table G-1a.
Continued

Income Category[a]	1979	1981	1983	1985	1987	1989	1991	1993	1995	1997 Under 1997 Law	1997 Under 2000 Law
					Effective Corporate Income Tax Rate						
Lowest Quintile	1.0	0.6	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.5	0.5
Second Quintile	1.4	0.8	0.6	0.6	0.9	0.8	0.6	0.8	0.8	0.7	0.7
Middle Quintile	1.6	1.0	0.9	0.9	1.2	1.1	1.0	1.1	1.2	1.1	1.1
Fourth Quintile	1.8	1.2	1.1	1.1	1.4	1.3	1.2	1.3	1.4	1.4	1.4
Highest Quintile	5.6	3.6	2.7	2.8	3.6	3.5	3.1	3.9	4.7	4.4	4.4
All Quintiles	3.4	2.2	1.8	1.8	2.4	2.3	2.0	2.5	2.9	2.9	2.9
Top 10 Percent	7.1	4.6	3.4	3.5	4.4	4.3	3.8	4.9	5.9	5.4	5.4
Top 5 Percent	9.0	5.6	4.2	4.3	5.4	5.3	4.7	6.0	7.2	6.3	6.3
Top 1 Percent	13.0	7.9	5.7	5.6	7.2	6.9	6.6	8.2	10.0	8.0	8.0
					Effective Federal Excise Tax Rate						
Lowest Quintile	2.1	1.6	1.9	2.5	2.5	1.9	2.3	2.5	2.7	2.8	2.8
Second Quintile	1.3	1.1	1.2	1.5	1.5	1.3	1.5	1.6	1.8	1.6	1.6
Middle Quintile	1.1	0.8	0.9	1.1	1.1	1.0	1.1	1.2	1.3	1.1	1.1
Fourth Quintile	0.9	0.7	0.8	0.9	0.9	0.8	0.9	0.9	1.1	0.9	0.9
Highest Quintile	0.7	0.6	0.6	0.6	0.6	0.5	0.6	0.6	0.7	0.5	0.5
All Quintiles	1.0	0.8	0.8	0.9	0.9	0.8	0.9	1.0	1.0	0.9	0.9
Top 10 Percent	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.4	0.4
Top 5 Percent	0.6	0.5	0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.4	0.4
Top 1 Percent	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.5	0.3	0.2	0.2

NOTES: (Continued)

Comprehensive household income equals pretax cash income plus income from other sources. Pretax cash income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, cash transfer payments, and retirement benefits plus taxes paid by businesses (corporate income taxes and the employer's share of Social Security, Medicare, and federal unemployment insurance payroll taxes) and employee contributions to 401(k) retirement plans. Other sources of income include all in-kind benefits (Medicare, Medicaid, employer-paid health insurance premiums, food stamps, school lunches and breakfasts, housing assistance, and energy assistance). Households with negative income are excluded from the lowest income category but are included in totals.

Individual income taxes are distributed directly to households paying those taxes. Payroll taxes are distributed to households paying those taxes directly or paying them indirectly through their employers. Federal excise taxes are distributed to households according to their consumption of the taxed good or service. Corporate income taxes are distributed to households according to their share of capital income.

a. Income categories are defined by ranking all people by their comprehensive household income adjusted for household size—that is, divided by the square root of the household's size. Quintiles, or fifths, of the income distribution contain equal numbers of people.

So if I could, I would like to see the correlation here, because I think one of the biggest lessons in this curve is that we have shifted the burden of taxation, and the tax cut that was passed last spring shifted it egregiously onto the backs of middle-income and lower-income taxpayers.

My question goes to something that you alluded to earlier, and that is the intergovernmental impacts of what you are telling us this morning. I know that CBO does have a role in measuring these intergovernmental impacts. Have you done any estimates of State budget shortfalls?

Mr. CRIPPEN. Senator, we have not done any independent estimates. We have been talking to the many groups, like the National Association of State Budget Officers and the National Governors Association (NGA), to try to monitor as best we can the developments there. The December report from the NGA was quite instructive, and you probably know of the deterioration in surplus pictures for many of the States, and of course, in many of them surrounding Washington, we are seeing headlines every day about billions of dollars of budget shortfalls.

So, yes, we are monitoring it, but we do not do independent estimates of what the States are going to have to face.

Senator CLINTON. Dr. Crippen, would the budget shortfalls and the unemployment increase, for example, require perhaps greater Medicaid outlays, and are those included in your baseline projections at this time?

Mr. CRIPPEN. Yes. We expect that both outlays for unemployment will be higher as well as Medicaid outlays, and they are included in the forecast today.

Senator CLINTON. And similarly, the impact on the States' revenues tied to Federal tax revenues, those declines, could you also give us some insight on that, because as some of these tax cuts kick in that were passed last spring, they are going to have a direct impact on State revenues.

Mr. CRIPPEN. We do not have an independent estimate of that, but we could probably provide you with one. You are absolutely right, of course, that as States mimic the Federal tax code, both in application and what the tax base ultimately is, if it changes at the Federal level, it could ultimately change States revenues as well and presumably in the same direction.

[The following was subsequently submitted for the record by Mr. Crippen:]

Dear Senator:

At the Senate Budget Committee hearing on January 23, you asked about the impact of cuts in Federal taxes on the States, many of which base their income taxes on Federal taxes. Although a complete analysis of the State revenue effects is beyond our capabilities, we can provide information about which provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) would affect State tax collections. Some provisions would affect all States; others would affect only a few.

We did survey other research organizations to determine whether they had examined the questions you posed. We found no estimates of EGTRRA's effects on State revenues. Much of the following discussion is based on work of the Center for Budget and Policy Priorities, only some of which is published

The principal impacts of EGTRRA on State revenues are on individual income tax and estate tax revenues. The seven States that have no individual income tax are affected only by changes in Federal estate tax laws. The other 43 States and the District of Columbia are likely to lose both income and estate tax revenue, although some States have acted to limit those losses. Furthermore, nine States allow residents to deduct Federal tax payments in calculating taxable income.[1] The income tax reductions in EGTRRA will lower those deductions and therefore increase State income tax liabilities.

INCOME TAXES

EGTRRA increased limits on contributions to retirement plans, including 401(k)s and individual retirement accounts (IRAs), as well as limits on benefits from defined benefit plans. For most taxpayers, contributions to 401(k)s and IRAs are ignored in calculating Federal taxable income; all States with income taxes except Pennsylvania follow the Federal rules for at least one program and will therefore lose revenues. Similarly, the higher limits on retirement benefits will reduce income tax revenues in all States with income taxes except Arkansas and Pennsylvania.

EGTRRA expanded tax benefits for education in various ways: making permanent the exclusion from income for employer-provided assistance; raising the limit on contributions to education IRAs; broadening the rules for deducting interest on student loans; expanding tax-free distributions from qualified prepaid tuition plans; and allowing most taxpayers to deduct some higher education expenses (although that provision expires after 2005). Nearly all States with income taxes will lose revenues from the education provisions in EGTRRA.[2]

Other parts of EGTRRA affect income taxes in fewer States. Phasing out the limitations on itemized deductions will reduce revenues in the 29 States (including New York) and the District of Columbia that follow Federal rules on itemized deductions. Similarly, the phasing out of limits on personal exemptions will affect revenues in 10 States (including New York). Increases in the standard deduction for married couples (beginning in 2005) will lower revenues in 10 States (not including New York). Earned income tax credit (EITC) changes in EGTRRA will increase State EITC benefits in 15 States (including New York) and the District of Columbia. Expansion of the Federal tax credit for dependent care will affect revenues in as many as 23 States (including New York) and the District of Columbia because those States use Federal definitions for their own dependent care credits. Finally, the higher exemptions allowed in the Federal alternative minimum tax (AMT) that lasts through 2004 will reduce revenues in the nine States (including New York) that levy an AMT based on Federal AMT calculations.

ESTATE TAXES

Changes in estate and gift taxes made in EGTRRA will affect every State, although some States have acted to reduce or eliminate the impact on State revenues.[3] Every State currently imposes a tax on estates that is at least as large as the credit allowed for State estate tax against Federal estate tax liability. Most States explicitly set their estate tax equal to the Federal credit. As the latter falls over the next decade, State taxes will generally fall. Furthermore, the credit phases out by 2005 when it is replaced by a deduction in calculating Federal estate taxes. If States act to maintain their 2001 tax levels, loss of the credit against Federal tax will impose additional tax liabilities on estates and generate pressure to reduce State level estate taxes.[4]

The District of Columbia and 37 States impose estate taxes equal to the Federal credit. For some States (including New York), the State tax equals the credit effective on a particular date prior to passage of EGTRRA.[5] The reduction and elimination of the Federal credit will not affect estate taxes in those States. Most States, however, tie their estate tax to the Federal credit in effect when the decedent dies.

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[1] The nine States are Alabama, Iowa, Louisiana, Missouri, Montana, North Dakota, Oklahoma, Oregon, and Utah.

[2] Only New Jersey and Pennsylvania are unaffected.

[3] Elizabeth C. McNichol, Iris J. Lav, and Daniel Tenny provide an excellent discussion of the impact of EGTRRA's estate and gift tax changes on State revenues in *States Can Retain Their Estate Taxes Even as the Federal Estate Tax is Phased Out*, Center on Budget and Policy Priorities, January 31, 2002.

[4] In recent years, many States that imposed estate taxes in excess of the credit allowed against Federal estate tax have changed their tax to match the credit. For example, in 1997 (but not effective until 2000), New York lowered its estate tax to equal the Federal credit, effectively limiting the State tax to a transfer from the Federal Government and eliminating any effect of the State tax on the total tax paid by estates.

[5] New York's estate tax conforms to the Federal tax as amended up through July 22, 1998, and therefore will not change as the provisions of EGTRRA phase in. Estates of New York residents dying after 2001 will not be able to claim a credit against Federal tax for the full amount of the State tax paid.

As the credit phases out over the next 4 years, estate tax revenues in those States will decline to zero, unless the States act to decouple their tax from Federal law. Already since the passage of EGTRRA, at least three States have set their estate taxes equal to the Federal credit before EGTRRA and thus protected their revenue streams. Other States are likely to follow suit.

Senator CLINTON. I think that information would be helpful to us. Certainly my State is in a unique position because of the extraordinary revenue shortfalls from September 11 that directly impacted on both the city and the State. But as I read the press, in any event, this is a phenomenon that is widespread across the country. Many Governors and State legislatures are facing significant shortfalls. And I think we are going to be called on here in the Congress to respond in some way. I am hoping that whatever package of economic recovery is put together will include a recognition of increasing health care costs and the need to help on that front in many of our States that have been hard-hit.

Dr. Crippen, I would also like to ask you about a comment that OMB Director Mitch Daniels made at a National Press Club speech back in November, in which he predicted deficits through at least 2005. He said that the new budget scenario called for "separating must-do from nice-to-do items." It is going to be difficult to have a good discussion about our budget when so much that is embedded in the budget already are must-dos. I mean, so many of the biggest spending items are required, they are mandatory, they are so-called entitlements, when we know that we are going to be asked for increases in defense spending, which many of us will be prepared to support. I know it would be hard for you to give me an exact number on this, but how much discretionary spending dollars are really in this budget projection that you are talking about in terms of what is available for non-defense, non-entitlement?

Mr. CRIPPEN. We assumed that this year's spending level, Senator, the level for the current year for all programs on the discretionary side, both domestic and defense, for purposes of today's forecast will grow only with inflation factors—inflation in the economy, but also in wages. So in that regard, we have not built in any increases for programs, any increases for homeland security, or increases for defense. None of those is in our baseline. So anything that the Congress and the President add to that would make the deficits worse and the surpluses smaller.

Senator CLINTON. That is very important, because clearly, I think a lot of people do not know that.

I have a statement[1], Mr. Chairman, that I would like to submit for the record, and I thank the Chairman for holding this hearing.

Chairman CONRAD. Without objection.

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. Thank you very much, and I will try my best to be brief.

Mr. Chairman, I would just like one more time to put in the record my analysis, which I believe comes out of your report, of why the Congressional Budget Office budget projections changed. And if you would get a pencil and pad and just write a few numbers down to see if we are correct.

[1] The prepared statement of Senator Clinton was not made availble by press time.

First, the January 2001 projection was for a $313 billion surplus. The legislative changes—and I will just package them into four items—tax law—by that, I mean an actual tax change that reduced taxes—and my number is $38 billion for the year that we are in, for the year that everybody is complaining about and concerned about. So the tax impact in that year was $38 billion. Is that correct or close to correct?

Mr. CRIPPEN. I believe so, yes.

Senator DOMENICI. Then, we had a defense appropriation and a non-defense appropriation, which were $33 billion and $11 billion, respectively.

Mr. CRIPPEN. Right.

Senator DOMENICI. Then, we got the giant of all giants, which we had nothing to do with, which the American people have kind of rightly understood, as I read what they are saying in the polls, and I would call that "recession," but let us be more specific and say "economic changes and technical changes." And I get two very giant numbers there—$148 billion and $94 billion.

Let me say, then, that 100 percent of the changes amounted to the following. The changes in the tax law by a tax cut measure were 12 percent. And I would just like to repeat that for those who keep saying that it is the tax cut that affected the reduction in our surplus—for the year that we are in, it was $38 billion, or a 12 percent impact.

Then, in the appropriated accounts, the defense appropriations and non-defense combined were $44 billion, which my number says 14 percent, Director Crippen.

And then, if I take those two giant ones that came with the recession, the so-called economic changes which you have explained in numbers went from 3-plus in growth to negative growth.

Mr. CRIPPEN. Yes.

Senator DOMENICI. That total number there is $148 billion plus $94 billion, so that is $242 billion.

Now let us just take those in percentages so everybody will get it, and you see if you think these are right. The total changes in the surplus were as follows: 12 percent from the tax law changes, that is, tax cuts; 14 percent from increased appropriations, that is, we spent more money on both defense and non-defense, and that number is 14 percent. So, we have 12 and 14. And then, the big ticket item that indeed changed everything, and that is the question of how long will it last—that is, how long before we get out of a recession—and that total was 72 percent of the reduction or diminution in the surplus.

Are we close to right, Mr. Director?

Mr. CRIPPEN. Yes, your numbers are right on.

Senator DOMENICI. OK. That means that the projections will yield a $21 billion negative, in the red, under these projections and these events that have occurred and that are rather easy to project—we are not going to miss these very far. Is that pretty close to right, that last statement?

Mr. CRIPPEN. I hesitate to say we are not going to miss them by very far—I would like to think that is right, yes.

Changes in CBO's Baseline Projections of the Surplus Since January 2001

(By fiscal year, in billions of dollars)

	2002	Total 2002-2011	% 2002	% 2002-2011
Total Surplus as Projected in January 2001	313	5,610		
Changes a/.				
Legislative.				
Tax act b/	(41)	(1,657)	12%	41%
Discretionary	(45)	(714)	14%	18%
Other	(5)	(49)	1%	1%
Subtotal	(91)	(2420)	27%	60%
Economic and Technical c/	(242)	(1,588)	73%	40%
Total	(333)	(4,008)	100%	100%
Surplus or Deficit (-) as Projected in January 2002	(21)	1,602		
Memorandum:.				
Legislative changes to discretionary spending a/.				
Defense	(34)	(396)	10%	10%
Nondefense	(11)	(318)	3%	8%

SOURCE: Congressional Budget Office.

a. These estimates include the interest effects of changes assumed.

b. CBO cost estimate for the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). The estimate includes bota a reduction in taxes and an increase in outlays.

c. Changes not directly driven by new legislation or by changes in the components of CBO's economic forecast are considered technical.

Senator DOMENICI. All right. I did this and did it slow. I think we will carry around a little chart so that when people give their speeches and say the Republican tax cut is what caused the recession and destroyed the surplus, I would like to put that up and each time say, well, what was it that brought the surplus to a negative number? I can go to these and say that as of this date, the neutral, independent body, the Congressional Budget office says—and right off, I want to repeat again, changes in the economy—that means you predicted 3.4 percent growth, but it turned out there was a negative growth, it got into a recession—and that one and the things that go with it were 72 percent of the loss of this surplus.

Now, there are people who really genuinely think we could have avoided that. I hear our Chairman say it, and I want to say that I look forward to working with him. But I really have seen nobody put forth a plan that would say that if we had followed this plan, we would never have had this problem.

Look, we had 10 years without a recession, and most people assumed we would have one at some time. I think there were a few of us—and I will put myself at the front of the line—who actually thought, Dr. Crippen—and in those moments, I did not call you and ask you to rid my brain of such a stupid thought—but I actually used to think that maybe we would not have the typical American downturn, and maybe it was gone forever—but I never said it publicly; whenever I said it, I said, of course, that is a pipedream, and it will come sooner or later. It came.

Now let me ask four or five specific questions. One, just for background, in the most recent budget resolution, the one prepared last year by the Republicans, we added $73.5 billion for agriculture.

That was on top of a current policy agriculture baseline that totaled $96.5 billion. Thus, the conjunction with the existing baseline at that time, the aggregate support totaled $170 billion over 10 years. Am I right so far?

Mr. CRIPPEN. So far.

Senator DOMENICI. Question: What is the total amount of your most recent agriculture baseline?

Mr. CRIPPEN. It is very close to those numbers, at about $100 billion.

Senator DOMENICI. OK. And Director Crippen, using the most recent baseline, what would be the cost of the current pending farm bill, Senate Bill 1731, that Majority Leader Daschle and Senators Harkin and Conrad have proposed to the Senate?

Mr. CRIPPEN. Senator, we have not priced the bill yet against the new baseline. We are, as you know, as of today just finalizing that baseline. I would guess, given the outlook for commodity prices, that it may well increase a little over what we said before, but that is only a guess.

Senator DOMENICI. OK. Now, Director Crippen, with the higher total cost of agriculture, having that in mind, and lowered budget surpluses over the next 10 years, what would be the total Medicare and Social Security dollars spent should 1731 pass the Senate?

Mr. CRIPPEN. I would like to avoid that question, but I am sure you will not let me. The——

Senator DOMENICI. Fine. You can avoid it.

Mr. CRIPPEN [continuing]. No, no. It is impossible to tell in some ways. You cannot trace dollars. They are all fungible. The point is that we are going to have deficits, so whatever surpluses exist in those trust funds will effectively be spent for something.

Senator DOMENICI. That answer is good enough for me. It just means that whatever we attempt to apply it to directly, we will have difficulty proving that it came out of Medicare or Social Security, and I think that is what you are saying.

Congress enacted a $40 billion emergency supplemental to respond to the terrorist attacks. Of that, $20 billion counted as budget authority in 2001; the other $20 billion counted as budget authority in 2002. How does CBO treat the $20 billion in 2002 emergency appropriations in this baseline that we are speaking to?

Mr. CRIPPEN. In this baseline, Senator, we add the $20 billion, all of it, into the baseline and then inflate it for the future, just as we do other budget authority.

Senator DOMENICI. All right.

On railroad retirement, if there were not directed scorekeeping—and the Chairman and I voted not to direct the scorekeeping, not to tell them how to count it—if CBO had done scored the bill in the typical manner instead of a manner that worked in behalf of the bill, what would that have cost the budget baseline this year?

Mr. CRIPPEN. It would have increased the deficit by about $15 billion.

Senator DOMENICI. So for those of us who said that, including the Chairman, we were correct on the floor when we said that.

Mr. CRIPPEN. Oh, absolutely. You agreed with us, so you could not help but be correct.

Senator DOMENICI. OK. I have one on Medicare and Social Security, but I will save it for another time. Thank you, I have nothing further.

Chairman CONRAD. Can I just followup on the point that Senator Domenici made? The former Chairman is exactly right with respect to this year's effect of the tax cut, and I pointed that out in my statement. But I think we also have to look at the 10 years, and the 10-year effect is this. The biggest impact in the reduction of the surplus over the 10 years is the tax cut and the associated interest cost. The next biggest is the economic changes, as pointed out in the CBO analysis. That is 23 percent. The next biggest is the legislation, largely the spending that was passed as a result of the attack on the United States on September 11. And the fourth biggest is the technical changes.

But in fairness, I think it is absolutely correct to say that for this year, the biggest impact, the biggest reason, is the recession; but over the 10 years, the biggest reason is the tax cut and the associated interest costs.

Senator Nelson.

Senator DOMENICI. Senator Nelson, would you yield for 30 seconds?

Senator NELSON. Of course.

Senator DOMENICI. Let me state for the record something that I did not say. We have heard a lot of negative talk because we have gone from a 330 surplus in this period of time, with the recession and other things, to negative numbers. Frankly, I would not want to let this event pass us by without saying that this is one Senator who has the greatest confidence in the American economy. We are besieged at this point by many things out of our control, not the least of which is a world economy led by Japan, and they are all taking a nosedive. It is very hard for us to stay positive in terms of numbers with those kinds of things. But I do believe that it is just a matter of time that this giant machine will come back to life and lead the world again. I am hopeful that we will be on the right track so that we do not impede that growth by our actions, and that means that we mean a stimulus package. The Chairman and I agree on that. We surely think that somebody ought to be looking at it in reality from the standpoint of doing some good—and I hope it is not political; I hope it is for doing some good.

Thank you.

Chairman CONRAD. You bet.

Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

In Florida, we have an expression: "There is more than one way to skin a cat."

Senator SARBANES. We have that expression in Maryland, too.

Senator NELSON. I am glad to hear that. It is an American expression.

Senator DOMENICI. Ours is a rabbit.

Senator NELSON. You, Senator Domenici, have skinned the cat showing the most favorable light in the point that you are trying to make with regard to the first year, that the tax cut has only a minimal effect on changing a revenue surplus situation to a deficit situation.

The Chairman has pointed out that over the decade-long period, the tax cut has an even greater effect, and we are still talking about whether we use the tax numbers that the Chairman is using plus the additional debt service as a result of the tax cut, or whether you just take the straight tax cut and you lump the whole debt service in your numbers later on as a result of tax cut and spending increases.

The fact is that the tax cut is getting awfully close, as I read your testimony, to what we said earlier this year in this committee, that this was not going to be what it was being sold as, as a tax cut of $1.35 trillion over 10 years; but instead was going to be closer to a $2 trillion tax cut over 10 years given the fact that in the 10th year, the tax cut evaporates, and obviously, a future Congress is not going to allow that to happen, but a future Congress is going to keep that tax cut in place in the 10th year.

So, looking at your figures and given the fact that in response to Senator Stabenow, you said that if the tax cut were continued for the 10th year like it is for years one through nine, there would be an additional deficit result of several hundred billion. That is what you said, is it not, Dr. Crippen?

Mr. CRIPPEN. For the two years, that is right.

Senator NELSON. OK. Then, if you take the Chairman's numbers and your numbers that the tax cut is worth $1.275 billion, and if you add the Chairman's increased debt service as a result—the Chairman's figure is about $389 billion—you are getting a tax cut in the range, rounded, of about $1.7 trillion—specifically, $1.683 trillion.

Mr. CRIPPEN. I certainly cannot take exception to your total. I would say one thing only, and that is that we have changed the 10-year period, obviously, from when we were talking about 1.2 trillion or 1.3 trillion last year to whatever we are talking about now; we have added a very expensive year or a big number year and dropped a small number year.

Second, while it is certainly true that these actions—reduced revenues and increased spending—will increase debt-service costs, I think it is not fair to conclude that that is a tax cut. That is to say, the effect of the legislation will be to reduce revenues and increase interest costs—that is certainly true—but I think that that interest cost is not going to anyone who is receiving a lower tax bill.

Am I making any sense?

Senator NELSON. Yes, you make sense, but it is a consequence of lessened revenue, so when we are looking at the question of surplus or deficit, it is a consequence of lessened revenue.

Mr. CRIPPEN. Absolutely.

Senator NELSON. So if the Chairman's figures are correct, somewhere around $1.6 to $1.7 trillion of revenue consequence, and then—a future Congress is not going to let the tax cut evaporate in the 10th year; it is going to continue it—and you said that that is worth several hundred billion dollars' worth in the 10th year, then, Mr. Chairman, you are right at $2 trillion, which is what we said instead of it being $1.35 trillion, you are going to use up the surplus because the tax cut in effect is going to be about $2 trillion over 10 years.

I would just make this additional point. At least in my campaign in the year 2000, and almost every other candidate running for office in the year 2000, a promise was made to the American people that we were not going to invade the Social Security or the Medicare surplus. It was put in terms that we will fence it off, we will wall it off, we will put up a firewall—we will not invade that surplus. And why? Why was there a consequence? Well, we said we do not want to fool with the Social Security surplus because that ought to be saved for Social Security and that if you do not spend the Social Security surplus, the result is that it is going to pay down the national debt.

Mr. Chairman, the figures that you have come up with over a 10-year period starting in 2002 to 2011 say that just the Social Security surplus, you are going to invade its trust fund moneys to the tune of $437 billion. And when you look at both of the Social Security and Medicare Trust Funds, you are going to invade it to the tune of almost three-quarters of a trillion dollars.

Now, that is breaking faith with what we said—not only to protect Social Security, but what that also is saying is that we are paying down the national debt under these projections by not doing any more spending, not even taking into account the 10th year of the tax cut that is going to have to be reenacted, we are still going to invade those surpluses and therefore not pay down the national debt to the tune of three-quarters of a trillion dollars over the 10-year period.

Chairman CONRAD. Would the Senator yield?

Senator NELSON. Of course.

Chairman CONRAD. Actually, the most recent numbers based on the numbers we have gotten here today are even worse—even worse—because what we see now is that you will be taking that amount just out of Social Security and on top of that, another $380 billion of Medicare Trust Fund money. So the total now is $1.1 trillion taken from the trust funds of Social Security and Medicare to pay for the President's tax cut and to pay for other expenses of the Federal Government. So trust fund moneys are being used for purposes for which they were not intended and for which everybody, including the President, pledged not to do——

Senator NELSON. Mr. Chairman, as a country lawyer, I would say I rest my case. We are going to continue this discussion quite a bit, but the numbers here are not only damaging, they are damning, from the testimony that came out of this committee a year ago.

Chairman CONRAD. I thank the Senator.

Senator Sarbanes.

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

Director Crippen, a year ago, what were the surplus or deficit figures you projected for the 10-year period?

Mr. CRIPPEN. For the 10-year period then, Senator, it was $5.6 trillion.

Senator SARBANES. A surplus of $5.6 trillion?

Mr. CRIPPEN. Over the 10 years, yes.

Senator SARBANES. That was before the tax cut was passed; correct?

Mr. CRIPPEN. Yes, that is correct.

Senator SARBANES. What are you projecting now for that period?

Mr. CRIPPEN. For the same period, $1.6 trillion, so $4 trillion less.

Senator SARBANES. Your projections have dropped from $5.6 trillion surplus to $1.6 trillion surplus?

Mr. CRIPPEN. Unfortunately, that is correct.

Senator SARBANES. Four trillion gone.

Do you take issue with this chart that the Chairman prepared—this is for the 10-year period—that projects that the loss of surplus, the $4 trillion that has been lost—about 70 percent of it, I guess, has been lost—that 42 percent of that, not quite half, but getting there, is as a consequence of the tax cuts; is that correct?

Mr. CRIPPEN. Yes.

Senator SARBANES. So the tax cuts—the economic changes are 23—the tax cuts are about twice as significant as any other item in terms of explaining that drop; is that correct?

Mr. CRIPPEN. Yes.

Senator SARBANES. OK. Now let me ask you this question. What are you now projecting for the 10-year period in terms of the surplus?

Mr. CRIPPEN. $1.6 trillion over the same 10 years as comparable there.

Senator SARBANES. No—you now update it a year——

Mr. CRIPPEN. $2.6 trillion; right.

Senator SARBANES [continuing]. You come in a year later, and now you extend it out, so you do it from 2002 to 2012, I think.

Mr. CRIPPEN. That is correct.

Senator SARBANES. What do you project as the surplus over that period of time?

Mr. CRIPPEN. It is $2.3 trillion.

Senator SARBANES. $2.3 trillion?

Mr. CRIPPEN. Yes.

Senator SARBANES. How much of that is in the last 2 years of the 10-year period?

Mr. CRIPPEN. $1.1 trillion.

Senator SARBANES. $1.1 trillion of the $2.3 trillion is in the last 2 years?

Mr. CRIPPEN. Right.

Senator SARBANES. So roughly half of it is in the last 2 years of the 10-year period; is that correct?

Mr. CRIPPEN. That is right.

Senator SARBANES. Of course, this tax cut that we have been discussing which has had such a profound effect is going to sunset in 2010; is that correct?

Mr. CRIPPEN. Yes.

Senator SARBANES. Supposedly.

Mr. CRIPPEN. Right.

Senator SARBANES. And I do not know of anyone who really—in fact, I think there is an effort now on the part of some of my Republican colleagues to make it permanent right now, if I am not mistaken. But in any event, so when you project the surpluses in 2011 and 2012, the $1.1 trillion that is half of the surplus that you are projecting, that is assuming that the tax cut will in fact sunset because that is what the current law provides; is that correct?

Mr. CRIPPEN. Right.

Senator SARBANES. How much of this surplus that you are projecting will come from the Social Security Trust Fund of the $2.3 trillion surplus?

Mr. CRIPPEN. More than the total—2.5 trillion over the 10 years—comes from Social Security.

Senator SARBANES. So you are projecting a $2.3 trillion surplus—that is unified surplus——

Mr. CRIPPEN. Right.

Senator SARBANES [continuing]. And you are projecting a $2.5 trillion surplus in the Social Security Trust Fund?

Mr. CRIPPEN. Yes, total off-budget, right.

Senator SARBANES. So you are projecting a deficit in the budget other than the Social Security Trust Fund; is that right?

Mr. CRIPPEN. That is right.

Senator SARBANES. So in order to avoid saying that we have a deficit, we in effect have to utilize the surplus of the Social Security Trust Fund; is that correct?

Mr. CRIPPEN. Correct.

Senator SARBANES. Mr. Chairman, I thought that everyone was making all kinds of undertakings and assurances that we would not be going into the Social Security Trust Fund surplus in order to achieve a budget surplus; is my recollection mistaken in that regard?

Chairman CONRAD. No. The Senator is exactly right. I think virtually everyone who is in public office promised not to use Social Security Trust Fund money for other purposes.

Senator SARBANES. So in effect, to avoid reflecting a deficit, which results 42 percent from these tax cuts, we are having to offset it with the Social Security Trust Fund surplus; correct?

Mr. CRIPPEN. That is correct.

Senator SARBANES. Intake into Social Security is from the payroll tax; is that correct?

Mr. CRIPPEN. Correct.

Senator SARBANES. And I think the payroll tax is generally recognized as falling most heavily on working people. It is not a progressive tax. It is seen as——

Mr. CRIPPEN. It is only a tax on labor, so it is not a tax on capital at all.

Senator SARBANES. No; it does not tax capital at all, and to the extent it taxes labor, it is a flat tax, which disproportionately affects lower-income people; isn't that correct?

Mr. CRIPPEN. It is capped somewhere in the neighborhood of $85,000.

Senator SARBANES. That is right. So above $85,000, you stop paying it; right?

Mr. CRIPPEN. Correct.

Senator SARBANES. So those taxes coming into the Social Security Trust Fund that create that surplus are being used to offset the deficit that is being run in order to give these tax cuts.

Now, I ask the Chairman if my recollection is mistaken. I understood that well over 50 percent of the benefit of the tax cuts went to the very top 1 percent, I think, of the income scale; is that correct?

Chairman CONRAD. I do not recall the exact percentage, but a disproportionate amount of the tax reduction went to the wealthiest 1 percent, even disproportionate to the amount of taxes that they pay.

Senator SARBANES. And in order to in effect assert that we do not have the budget in deficit, and if we are using the Social Security Trust Fund surplus in order to do that, we in effect are using the revenues that are gained through the payroll tax, which disproportionately hits working people. So you have a double blow here. You have the revenue inflow used to try to create a surplus situation coming disproportionately from working people, and you have the tax cuts going disproportionately to people at the upper end of the income scale. So the working people get hit twice under this arrangement as I perceive it.

Chairman CONRAD. It is a perverse result of what has occurred, and in effect you are taking payroll tax dollars to fund in part an income tax cut that disproportionately goes to the wealthiest earners in the country.

Senator SARBANES. I am sure that we will explore that point further as we go through these hearings.

Mr. Chairman, I see there is a vote on, and I know we have to draw this to a close, but I very much appreciate your yielding. And Director Crippen, we are pleased to have you back before the committee.

Chairman CONRAD. I want to thank all of my colleagues on the committee. We do have just a few minutes remaining in the vote, so we will have to leave. I want to again thank you, Director Crippen, for being here and for your answers to these questions. Obviously, we have differences of opinion on the issues, those of us who are seated here, but we very much appreciate your sharing your projections with us and the very hard work done by you and your committee staff to prepare this work on a timely basis for the consideration of the Congress.

Mr. CRIPPEN. Thank you, Mr. Chairman.

Chairman CONRAD. The committee is adjourned.

[Whereupon, at 12:25 p.m., the committee was adjourned.]

OPENING STATEMENT OF SENATOR GORDON SMITH

Good morning—and I'd like to thank you the Chairman and ranking member for the hearing and say that I'm looking forward to working with both sides of the aisle to produce a real bipartisan budget this year.

Like many on this committee I want to produce a budget that will do much to protect our Nation, bolster our troops in the fight against terrorism and address a host of domestic issues at home—in my State of Oregon.

I would also like to say at the outset that I'm against any increases in taxes—I strongly believe that the current tax cuts must stay intact and their effect will do much to bloster the pocketbooks of Oregonians who paid—sent their money, in good faith, to Washington, DC.

One of my top priorites this year will be to direct funding toward the uninsured. It is nothing short of a moral outrage that so many Americans lack health insurance coverage even as they live and work in the wealthiest Nation on earth. I have worked in the past with my colleague and friend, Senator Wyden who also sits on this committee. And I can promise you that this year we will again join forces in the effort to bring health insurance to those in Oregon and across the Country who lack coverage.

Mr. Crippen, I welcome you back before the Senate Budget Committee and I look forward to your testimony.

PREPARED STATEMENT OF SENATOR CHUCK GRASSLEY

With today's announcement that the Federal Government is once again facing near-term budget deficits, we're going to hear a lot of talk from the critics about the need to postpone or even repeal last year's bipartisan tax cut.

The critics say we should revisit the tax cut for two reasons. First, they claim the tax cut is responsible for our return to budget deficits. Second, the critics claim the tax cut will jeopardize our long-term economic growth. Let's consider each of these claims in turn.

According to the Congressional Budget Office's projections, the tax cut is responsible for less than 15 percent of the reduction in this year's surplus and less than 40 percent of the reduction in surpluses over the next 10 years. The slowdown in our economy and the additional spending enacted last year are responsible for most of the deterioration in our budget outlook.

The second criticism is that the tax cut will reduce the surplus, thereby exerting upward pressure on interest rates, and thus reduce future economic growth. A recent report by the Joint Economic Committee, however, concludes there is no evidence to support this criticism. According to the JEC, "empirical studies on interest rates have uniformly failed to find any statistically significant relationship between interest rates and the budget balance of the U.S. Government." This result is likely due to the fact that the deficits we have seen in the past were not large enough to affect interest rates given the overall size of our financial markets.

If the tax cut is not responsible for rising deficits and higher interest rates, why do the critics still complain? One reason they want to delay or repeal the tax cut is because they want to spend the money. Some critics have already announced their plans to spend the tax cuts. As more of their spending plans become public, it will become obvious their cries for "fiscal discipline" are nothing more than crocodile tears.

In addition to the critics who want to spend the tax cut, there are also critics who insist we cannot afford the tax cut because our long-term budget projections show Federal spending will exceed revenue by 25 percent within 50 years.

To argue we cannot afford a modest tax cut today because we will need a huge tax increase in the future is to ignore the obvious. Congress cannot provide more government than taxpayers are willing to pay for. Throughout our country's history the Federal Government has never taken more than one-fifth of our Nation's income in taxes. If we are not willing to pay 25 percent more for government, why should we expect our children and grandchildren to do so? Our challenge today is to get beyond the rhetoric and begin to make government affordable once again.

BUDGET AND ECONOMIC OUTLOOK

THURSDAY, JANUARY 24, 2002

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

The committee met, pursuant to notice, at 10:05 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad (chairman of the committee) presiding.

Present: Senators Conrad, Hollings, Sarbanes, Murray, Wyden, Feingold, Johnson, Byrd, Nelson, Stabenow, Clinton, Corzine, Domenici, Grassley, Bond, Gregg, Snowe, Smith, Allard, and Hagel.

Staff present: Mary Ann Naylor, staff director; and Chad Stone, chief economist.

For the minority: G. William Hoagland, staff director; and Cheri Reidy, senior analyst.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome Chairman Greenspan this morning. It is good to have you here to testify before the committee. As many of us commented yesterday, what a difference a year makes.

Last year, the Congressional Budget Office projected that we would be able to expect $5.6 trillion of surpluses over the next decade. Yesterday, the Director of the Congressional Budget Office sat in that chair, Chairman Greenspan, and told us that the $5.6 trillion of projected surpluses were reduced to $1.6 trillion, and that is before any additional defense buildup the President is apparently about to propose or any additional funding for homeland defense or any stimulus package or a farm bill or any other new spending initiatives.

Last year, Chairman Greenspan, you testified that we were in danger of paying off the debt too quickly. And while you sounded cautionary notes, and sent many signals in your testimony that we have got to be careful not to return to deficits and debt, unfortunately very few in this town paid much attention to your cautionary notes.

Many people heard what they wanted to hear, and they claimed that we could have it all: that we could have a massive tax cut, that we could have a major defense buildup, that we could protect every penny of the Social Security and Medicare Trust Funds, and that we could have a maximum paydown of our national debt. Unfortunately, we now know that was not true.

As we heard yesterday in Director Crippen's statement, there would be no surplus over the next decade without the trust funds of Social Security and Medicare. In fact, instead of a $2.7 trillion non-trust fund surplus, we would have a $1.1 trillion deficit.

And last year, we were told that we would be debt free by 2008, or effectively debt free. Yesterday, Director Crippen made clear that we will have $2.8 trillion in national debt instead of being debt free. The reasons for the change? Well, in Director Crippen's testimony, it was clear that over the 10 years the biggest reason for the decline in the surpluses is the tax cut, accounting for 42 percent of the reduction. The other factors are on this chart. Economic changes account for 23 percent; other legislation, largely spending as a result of the attack on this country, 18 percent; and technical changes, 17 percent.

So the question before this committee is: What do we do? In order to answer that question, we first have to analyze the current status of the economy. That is one reason you were invited here today, and we welcome your testimony.

We see that unemployment is still rising. We are now at 8.3 million people unemployed in the country. But at the same time, there are some hopeful signs. We see consumer confidence starting to rise. It is now ticking up. And so the fundamental question before us: What should the budget policy of the United States be in order to foster stronger economic growth and put this country in a position to meet its long-term obligations?

I believe that fiscal discipline matters to the markets. That is something that you have made clear. In your remarks earlier this month in San Francisco, you said—and I just want to quote—"Some of this stimulus has been likely offset by increases in long-term market interest rates, including those on home mortgages. The recent rise in these rates largely reflects the perception of improved prospects for the United States economy. But over the past year, some of the firmness of long-term interest rates probably is the consequence of the fall of projected budget surpluses and the implied less rapid paydown of the Federal debt."

And, indeed, when we look to specific indicators and interest rates, what we see is that while you and your colleagues at the Federal Reserve have aggressively reduced short-term rates, long-term rates have stayed stubbornly where they were. We can see in 30-year conventional mortgages virtually no reduction over this period in which you and your colleagues have so aggressively used monetary policy to attempt to give lift to this economy.

Mr. Chairman, in the past you have argued strongly about the desirability of paying down debt to help keep long-term interest rates down. Again, I turn to your words of just last year at about this time: "All else being equal, a declining level of Federal debt is desirable because it holds down long-term real interest rates, thereby lowering the cost of capital and elevating private investment. The rapid capital deepening that has occurred in the United States economy in recent years is a testimony to those benefits."

Now, I believe you were right then and you are right now to make that point.

But there is another key reason for fiscal discipline and for attempting to rebuild surpluses, and that is the demographic time bomb that we face as we approach the time the baby-boomers will start to retire. This circumstance is fundamentally different than the budget crisis we faced in the 1980's because then we had time to recover. Now there is no time to recover. The first baby-boomers start to retire in just 6 years.

As Director Crippen said yesterday, acting sooner rather tan later to address these long-term fiscal imbalances will make a real difference.

Finally, Mr. Chairman, in your testimony last year, you warned us that budget projections are highly uncertain, and you urged us to have a plan to protect surpluses and debt reduction. You suggested something like a trigger. We did not follow that advice, regrettably. Some of us were strong advocates, including members on both sides of the dais here, certainly Senator Stabenow on our side and Senator Snowe on the Republican side warned us that we should take your advice and put in place such a mechanism.

I think now the evidence is clear that that should have been pursued, and perhaps you can give us counsel on how we best do that now.

Again, Chairman Greenspan, I welcome your presence here today and look forward to your testimony. I turn now to my very able colleague, the ranking member, the Senator from New Mexico.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much, Mr. Chairman, and welcome, Dr. Greenspan. It is always good for us to have you here.

I am told that this is your 18th appearance before the Senate Budget Committee, as the Chairman of the Council of Economic Advisers, as a private citizen, and as Chairman of the Federal Reserve. That is quite a record, although I am not sure whether to congratulate you or to pity you. In either event, you seem to like coming back, and we like to have you come back. So we are going to call it something to be congratulatory about.

As the committee discussed yesterday, Dr. Greenspan, with the CBO Director Dan Crippen, things are clearly different than a year ago. The last time you testified before our committee was a year ago. At that time the Congressional Budget Office was saying that the 10-year baseline surplus was $5.6 trillion compared to a publicly held debt of $3.4 trillion. A year ago, you were concerned that the budget surplus might grow so large and be so persistent that there was a good, real possibility and threat of the Federal Government accumulating private assets, which you said would undermine long-term productivity growth.

You were also concerned then that the Federal Government could end up paying large premiums to bond holders by trying to retire long-term debt before it matured. You recommended that we adopt a budget strategy that smoothed the glide path toward the minimum level of publicly held debt.

You cautioned against coming upon the minimum debt level in an abrupt way in which the Government could only avoid accumulating assets by suddenly reducing taxes or increasing spending regardless of where the United States was in the business cycle.

It seems to me that the combination of President Bush's tax cut, the war on terror, and the economic downturn have accomplished your goal of smoothing the glide path toward the minimum debt level.

Last year, the baseline showed us—— [Laughter.]

Senator DOMENICI. You want to laugh first?

Chairman CONRAD. Was it a joke?

Senator DOMENICI. No, it wasn't a joke, but if you would like to laugh, it would be fine. Then I could complete it. Everything all right? [Laughter.]

Senator DOMENICI. I didn't bring many of my people along today because I didn't get a chance to show them that, and I didn't know what their reaction would be. So I left them somewhere. They will be along shortly.

So let me repeat. It seems to me that the combination of President Bush's tax cut, the war on terror, and the economic downturn have accomplished your goal of smoothing the glide path toward the minimum debt level. Last year, the CBO baseline showed us reaching a net debt of zero in 2009. Now the net debt is on a schedule to reach zero at 2014. For all the rhetoric about the end of fiscal discipline, the new CBO baseline shows publicly held debt dropping to about 7 percent in 2012, the lowest debt-to-GDP ratio since 1917.

Some of my colleagues may try to get you to apologize or issue some sort of mea culpa for your testimony last year. But the way I see it, we are now in exactly the fiscal situation you suggested we should be in: a smoother glide path toward a minimum debt.

It is true that in the near term we will experience deficits, and as you look back at your testimony, that is what was expected last year. But we have had a recession and a war, at least the beginnings of a war in between. If there is any time when a deficit is not just acceptable but probably preferable, it is when the country is at war and the economy is contracting.

At this time we have to be focused on domestic programs to secure our citizens from terrorist attacks, securing their economic future, and providing our military with whatever it needs to fight this war and win it. It is our responsibility to produce a budget that preserves the security of our citizens on all these fronts: their national security, their personal security, and their economic security. Nothing much less can matter at this time.

I hope we can work together on a budget plan that focuses on these three security issues. I look forward to the Chairman's testimony this morning, and in the oncoming days and weeks that we can work together here as a committee in a real way to do what I have just described would be done on your part and the executive branch.

Thank you, Mr. Chairman. It is a pleasure to be here this morning.

Chairman CONRAD. Chairman Greenspan, we again welcome you to the committee and look forward to your testimony.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Dr. GREENSPAN. Thank you very much, Mr. Chairman and members of the committee.

Mr. Chairman, I am going to excerpt from my prepared remarks and request that the full text be included in the record.

Chairman CONRAD. Without objection.

Dr. GREENSPAN. This morning I would like to offer some general comments about the state of the economy before turning to the Federal budget. I want to emphasize here that I speak for myself and not necessarily for the Federal Reserve.

It is clear that the United States economy went through a significant cyclical adjustment in 2001 that was exacerbated by the effects of the terrorist attacks on September 11. That adjustment was characterized by sharp reductions in business investment and pronounced liquidations in business inventories, and was compounded by the simultaneous economic difficulties of some of our major trading partners. But there have been signs recently that some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm.

One key consideration in that assessment is the behavior of inventories. Stocks in many industries have been drawn down to levels at which firms will soon need to taper off their rate of liquidation, if they have not already done so. Any slowing in the rate of inventory liquidation will include a rise in industrial production if demand for those products is stable or is falling only moderately. That rise in production will, other things being equal, increase household income and spending. The runoff of inventories, even apart from the large reduction in motor vehicle stocks, remained sizable in the fourth quarter. Hence, with production running well below sales, the potential positive effect on income and spending of the inevitable cessation of inventory liquidation could be significant.

But that impetus to activity will be short-lived unless sustained growth of final demand kicks in before the positive effects of the swing from inventory liquidation to accumulation dissipate. Most recoveries in the post-World War II period received a boost from a rebound in demand for consumer durables and housing from recession-depressed levels in addition to some abatement of the liquidation of inventories. Through most of last year's slowdown, in contrast to the usual pattern, the household sector was a major stabilizing force. As a consequence, although household spending should continue to trend up, the potential for significant acceleration in activity in this sector is more limited.

In fact, there are a number of pluses and minuses in the outlook for household spending. Low mortgage interest rates and favorable weather have provided considerable support to homebuilding in recent months. Moreover, attractive mortgage rates have bolstered both the sales of existing homes and the realized capital gains that those sales engender. They have also spurred refinancing of existing homes and the associated liquification of increases in house values. These gains have been important to the ongoing extraction of home equity for consumption and home modernization. The pace of such extractions likely dropped in response to the decline in refinancing activity that followed the backup in mortgage rates that began in early November. But mortgage rates remain at low levels and should continue to provide support to activity in this sector.

Consumer spending received a considerable lift from the sales of new motor vehicles, which were remarkably strong in October and November owing to major financing incentives. Sales have receded some as incentives were scaled back, but they have remained surprisingly resilient. Other consumer spending appears to have advanced at a moderate pace in recent months.

The substantial declines in the prices of natural gas, fuel oil, and gasoline have clearly provided some support to real disposable income and spending. To have a more persistent effect on the ongoing growth of total personal consumption expenditures, energy prices would need to continue declining. Futures prices do not suggest that such a decline is in the immediate offing, but the forecast record of these markets is less than sterling.

Although the quantitative magnitude and the precise timing of the wealth effect remain uncertain, the steep decline in stock prices since March 2000 has no doubt curbed the growth of household spending. Although stock prices recently have retraced a portion of their earlier losses, the restraining effects from the net decline in equity values presumably have not, as yet, fully played out. Future wealth effects will depend importantly on whether corporate earnings improve to the extent currently embedded in share prices.

Perhaps most central to the outlook for consumer spending will be developments in the labor market. The pace of layoffs quickened last fall, especially after September 11, and the unemployment rate rose sharply. Over the past month or so, however, initial claims for unemployment insurance have decreased markedly, on balance, suggesting some abatement in the rate of job loss.

Although this development would be welcome, the unemployment rate may continue to rise for a time, and job losses could put something of a damper on consumer spending.

The dynamics of inventory investment and the balance of factors influencing consumer demand will have important consequences for the economic outlook in coming months. But the broad contours of the present cycle have been and will continue to be driven by the evolution of corporate profits and capital investment.

The retrenchment in capital spending over the past year was central to the sharp slowing we experienced in overall economic activity. The steep rise in high-tech spending that occurred in the early post-Y2K months was clearly not sustainable. The demand for many of the newer technologies was growing rapidly, but capacity was expanding even faster, exerting severe pressure on prices and profits. New orders for equipment and software hesitated in the middle of 2000 and then fell sharply as firms re-evaluated their capital investment programs. In most cases, businesses required that new investments pay off much more rapidly than they had previously. For much of last year, the resulting decline in investment outlays was fierce and unrelenting.

These cutbacks in capital spending interacted with, and were reinforced by, falling profits and equity prices. Indeed, a striking feature of the current cyclical episode relative to many earlier ones has been the virtual absence of pricing power across much of American business, as increasing globalization and deregulation have enhanced competition. In this low-inflation environment, firms have perceived very little ability to pass cost increases on to customers. The result has been that profit margins are still under pressure.

Business managers with little opportunity to raise prices have moved aggressively to stabilize cash-flows by trimming work forces. These efforts have limited the rise in unit costs, attenuated the pressure on profit margins, and ultimately helped to preserve the vast majority of private-sector jobs. To the extent that businesses are successful in stabilizing and eventually boosting profits and cash-flow, capital spending should begin to recover more noticeably.

Such success would likely be accompanied by a decline in elevated risk premiums back to more normal levels and, with real rates of return on high-tech equipment still attractive, should provide an additional spur to new investment.

The evidence strongly suggests that new technologies will present ample opportunities to earn enhanced rates of return. Indeed, reports from businesses around the country suggest the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began.

If the recent more favorable economic developments continue and gather momentum, uncertainties will diminish, risk premiums will fall, and the pace of capital investment embodying these technologies will increase. As we have witnessed so clearly in recent years, the resulting enhanced growth of productivity will lift our standards of living.

The economic and financial developments I have described, of course, have important implications for the Federal budget and can help explain a significant portion of the shift in the budget situation over the past year. A year ago, the Congressional Budget Office expected the unified surplus to continue to mount if no new policy actions were taken and to cumulate to $5.6 trillion for fiscal years 2002 to 2011, as Dr. Crippen testified yesterday.

As you know, if today's policies remain in place, CBO is currently forecasting a cumulative surplus over the same 10 years that is $4 trillion below what had been anticipated in its baseline a year ago.

Despite the erosion in the budget picture over the past year, our underlying fiscal situation today remains considerably stronger than that of a decade ago, when policymakers were struggling to rein in chronic deficits. The shift from a deficit equal to nearly 5 percent of GDP in fiscal year 1992 to a surplus equal to 2.5 percent of GDP in fiscal year 2000 was truly remarkable. Restraint on outlays accounted for about 40 percent of the fiscal reversal over this period, and revenue growth in excess of GDP growth accounted for about 45 percent; the associated declines in debt service accounted for the remainder. The fall in non-interest outlay share of GDP largely reflected lower defense spending as the cold war came to an end, but other spending also was fairly well restrained. At least until the past few years, the statutory caps helped to hold nondefense discretionary expenditures in check, and the pay-as-you-go rules forced careful consideration of deficit-expanding initiatives.

The extraordinary rise in receipts over the past decade resulted from the exceptional performance of the United States economy and the associated rise in the market value of assets, which helped lift receipts from 17.5 percent of GDP in fiscal year 1992 to a postwar high of nearly 21 percent of GDP in fiscal year 2000. The increase in receipts in the second half of the 1990's was particularly impressive—especially for individual income taxes, which grew about 11 percent per year on average between 1995 and 2000. The surge in individual taxes was attributable in part to the strong growth in incomes from production and to the tendency of rising levels of income to shift a greater share of taxable income into higher tax brackets.

But individual taxes also received a boost from the enormous rise in the value of financial assets during that period—directly through taxes on higher capital gains realizations and indirectly through the taxes collected from the exercise of stock options, from stock-price-related bonuses to workers in the financial industry, and from withdrawals from capital-gains-augmented IRAs and 401(k) plans.

Estimates based in part on data from the Statistics of Income and other sources suggest that such market-related receipts accounted for only about 15 percent of total individual receipts in fiscal year 1995; but because they grew about 25 percent per year on average between 1995 and 2000, they accounted for more than one-third of the increase in total individual receipts over that period. Receipts that are more directly related to production in the broader economy—that is, those associated with wages and salaries, business and professional incomes, dividends, and interest income—rose 8.5 percent per year on average between 1995 and 2000, one-third the pace of receipts on stock-market-related taxable incomes.

Recent developments, of course, have reversed part of this fiscal bonanza. Tax cuts, the weakening in economic activity, and the sharp decline in stock prices have reduced individual tax receipts. In addition, taxes on capital gains realizations have become an increasingly important component of corporate receipts in recent years, perhaps as much as one-fourth. Consequently, declines in stock prices have exerted additional downward pressure on corporate receipts, which had already taken a large hit from declining profit margins.

Increased funding for defense and homeland security and the higher expenditures on unemployment benefits and other cyclically sensitive programs are also pressing on our current-policy fiscal balances. Such calculations, of course, do not include the additional expenditures that doubtless will be authorized as the year progresses.

The current-policy budget outlook prepared by the Congressional Budget Office for the coming decade, though less favorable than a year ago, is still quite positive. CBO remains reasonably sanguine about the economy's growth prospects for the next 10 years, and this is reflected in the re-emergence in its current-policy projections of moderate unified budget surpluses by the middle of the decade. If realized, such surpluses, by lowering the publicly held Federal debt and freeing up private saving to be channeled into capital investment, would help us prepare for the considerable demographic changes that we face over the longer run. This will clearly be no simple task. As Dr. Crippen emphasized yesterday, the fiscal pressures that will almost surely arise after 2010 will be formidable.

Achieving a satisfactory budget posture will depend on ensuring that new initiatives are consistent with our longer-run budgetary objectives. Indeed, as you craft a budget strategy for coming years, you might again want to consider provisions that, in some way, would limit tax and spending initiatives if specified targets for the budget surpluses and Federal debt were not satisfied.

The significant improvement in the budget in the 1990's reflected not only decidedly positive economic forces but also much hard work and many difficult decisions on the part of this committee and others. Similar efforts will be required in the years ahead.

Thank you, Mr. Chairman. I look forward to your questions.

Chairman CONRAD. Thank you, Chairman Greenspan.

[The prepared statement of Dr. Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE BOARD

Mr. Chairman and members of the committee, in just a few weeks, the Federal Reserve Board will submit its semiannual report on monetary policy to the Congress. That report, and my accompanying testimony, will give our detailed assessment of the outlook for the United States economy and the implications of that outlook for monetary policy. This morning, I would like to offer some general comments about the state of the economy before turning to the Federal budget. I want to emphasize that I speak for myself and not necessarily for the Federal Reserve. it is clear that the United States economy went through a significant cyclical adjustment in 2001 that was exacerbated by the effects of the terrorist attacks on September 11. That adjustment was characterized by sharp reductions in business investment and pronounced liquidations in business inventories and was compounded by the simultaneous economic difficulties of some of our major trading partners. But there have been signs recently that some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm.

One key consideration in that assessment is the behavior of inventories. Stocks in many industries have been drawn down to levels at which firms will soon need to taper off their rate of liquidation, if they have not already done so. Any slowing in the rate of inventory liquidation will induce a rise in industrial production if demand for those products is stable or is falling only moderately. That rise in production will, other things being equal, increase household income and spending. The runoff of inventories, even apart from the large reduction in motor vehicle stocks, remained sizable in the fourth quarter. Hence, with production running well below sales, the potential positive effect on income and spending of the inevitable cessation of inventory liquidation could be significant.

But that impetus to activity will be short-lived unless sustained growth of final demand kicks in before the positive effects of the swing from inventory liquidation to accumulation dissipate. Most recoveries in the post-World War II period received a boost from a rebound in demand for consumer durables and housing from recession-depressed levels in addition to some abatement of the liquidation of inventories. Through most of last year s slowdown, in contrast to the usual pattern, the household sector was a major stabilizing force. As a consequence, although household spending should continue to trend up, the potential for significant acceleration in activity in this sector is more limited.

In fact, there are a number of pluses and minuses in the outlook for household spending. Low mortgage interest rates and favorable weather have provided considerable support to homebuilding in recent months. Moreover, attractive mortgage rates have bolstered both the sales of existing homes and the realized capital gains that those sales engender. They have also spurred refinancing of existing homes and the associated liquification of increases in house values. These gains have been important to the ongoing extraction of home equity for consumption and home modernization. The pace of such extractions likely dropped in response to the decline in refinancing activity that followed the backup in mortgage rates that began in early November. But mortgage rates remain at low levels and should continue to provide support to activity in this sector.

Consumer spending received a considerable lift from the sales of new motor vehicles, which were remarkably strong in October and November owing to major financing incentives. Sales have receded some as incentives were scaled back, but they have remained surprisingly resilient. Other consumer spending appears to have advanced at a moderate pace in recent months.

The substantial declines in the prices of natural gas, fuel oil, and gasoline have clearly provided some support to real disposable income and spending. To have a more persistent effect on the ongoing growth of total personal consumption expenditures, energy prices would need to continue declining. Futures prices do not suggest that such a decline is in the immediate offing, but the forecast record of these markets is less than sterling.

Although the quantitative magnitude and the precise timing of the wealth effect remain uncertain, the steep decline in stock prices since March 2000 has, no doubt, curbed the growth of household spending. Although stock prices recently have retraced a portion of their earlier losses, the restraining effects from the net decline in equity values presumably have not, as yet, fully played out. Future wealth effects will depend importantly on whether corporate earnings improve to the extent currently embedded in share prices.

Perhaps most central to the outlook for consumer spending will be developments in the labor market. The pace of layoffs quickened last fall, especially after September 11, and the unemployment rate rose sharply. Over the past month or so, however, initial claims for unemployment insurance have decreased markedly, on balance, suggesting some abatement in the rate of job loss.

Although this development would be welcome, the unemployment rate may continue to rise for a time, and job losses could put something of a damper on consumer spending. However, the extent of such restraint will depend on how much of any rise in unemployment is the result of weakened demand and how much reflects strengthened productivity. In the latter case, average real incomes could rise, at least partially offsetting losses of purchasing power that stem from diminished levels of employment. Indeed, fragmentary data suggest that productivity has held up quite well of late.

The dynamics of inventory investment and the balance of factors influencing consumer demand will have important consequences for the economic outlook in coming months. But the broad contours of the present cycle have been, and will continue to be, driven by the evolution of corporate profits and capital investment.

The retrenchment in capital spending over the past year was central to the sharp slowing we experienced in overall activity. The steep rise in high-tech spending that occurred in the early post-Y2K months was clearly not sustainable. The demand for many of the newer technologies was growing rapidly, but capacity was expanding even faster, exerting severe pressure on prices and profits. New orders for equipment and software hesitated in the middle of 2000 and then fell sharply as firms re-evaluated their capital investment programs. Uncertainty about economic prospects boosted risk premiums significantly, and this rise, in turn, propelled required, or hurdle, rates of return to markedly elevated levels. In most cases, businesses required that new investments pay off much more rapidly than they had previously. For much of last year, the resulting decline in investment outlays was fierce and unrelenting. Although the weakness was most pronounced in the technology area, the reductions in capital outlays were broad-based.

These cutbacks in capital spending interacted with, and were reinforced by, falling profits and equity prices. Indeed, a striking feature of the current cyclical episode relative to many earlier ones has been the virtual absence of pricing power across much of American business, as increasing globalization and deregulation have enhanced competition. In this low-inflation environment, firms have perceived very little ability to pass cost increases on to customers. Growth in hourly labor compensation has slowed in response to deteriorating economic conditions, but even those smaller increases have continued to outstrip gains in output per hour for the corporate sector on a consolidated basis. The result has been that profit margins are still under pressure.

Business managers, with little opportunity to raise prices, have moved aggressively to stabilize cash-flows by trimming work forces. These efforts have limited the rise in unit costs, attenuated the pressure on profit margins, and ultimately helped to preserve the vast majority of private-sector jobs. To the extent that businesses are successful in stabilizing and eventually boosting profits and cash-flow, capital spending should begin to recover more noticeably.

Such success would likely be accompanied by a decline in elevated risk premiums back to more normal levels and, with real rates of return on high-tech equipment still attractive, should provide an additional spur to new investment. When capital spending fully recovers, its growth is likely to be less frenetic than that which characterized 1999 and early 2000—a period during which outlays were boosted by the dislocations of Y2K and the extraordinarily low cost of capital faced by many firms.

Still, the evidence strongly suggests that new technologies will present ample opportunities to earn enhanced rates of return. Indeed, reports from businesses around the country suggest that the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began. Many business managers are still of the view, according to a recent survey of purchasing managers, that less than half of currently available new, and presumably profitable, supply chain technologies have been put into use.

If the recent more-favorable economic developments continue and gather momentum, uncertainties will diminish, risk premiums will fall, and the pace of capital investment embodying these technologies will increase. As we have witnessed so clearly in recent years, the resulting enhanced growth of productivity will lift our standard of living.

The economic and financial developments I have described, of course, have important implications for the Federal budget and can help explain a significant portion of the shift in the budget situation over the past year. A year ago, the Congressional Budget Office expected the unified surplus to continue to mount if no new policy actions were taken and to cumulate to $5.6 trillion for fiscal years 2002 to 2011.

As you know, if today s policies remain in place, CBO is currently forecasting a cumulative surplus over the same 10 years that is $4 trillion below what had been anticipated in its baseline a year ago. CBO calculates that the now less favorable economic assumptions—especially in the near term—contribute nearly $1 trillion—after taking account of the associated cost of debt service—to the downward revision in its 10-year surplus projections. In addition, more than $600 billion of the downward revision reflects CBO s view that the 10-year estimates it made a year ago of receipts relative to taxable incomes were too high; the revision was based in part on the recent disappointing tax collections and lowered estimates of realized capital gains in the wake of stock market declines.

If CBO had been able to employ what has been learned about recent developments and the long-term outlook in the past year—that is, if it had used its current economic and technical assumptions when it put together its budget projections last January—a still formidable surplus would have emerged. Instead of projecting a $5.6 trillion current-policy surplus, it would have estimated $4 trillion.[1] Of course, legislated tax and spending actions over the past year, as estimated by CBO, have reduced the 10-year surplus by $2.4 trillion. This leaves a current-policy 10-year surplus expectation of $1.6 trillion through fiscal 2011.

Despite the erosion in the budget picture over the past year, our underlying fiscal situation today remains considerably stronger than that of a decade ago, when policymakers were struggling to rein in chronic deficits. The shift from a deficit equal to nearly 5 percent of GDP in fiscal 1992 to a surplus equal to 2–1/2 percent of GDP in fiscal 2000 was truly remarkable. Restraint on outlays accounted for about 40 percent of the fiscal reversal over this period, and revenue growth in excess of GDP growth accounted for about 45 percent; the associated declines in debt service accounted for the remainder. The fall in the non-interest outlay share of GDP largely reflected lower defense spending as the cold war came to an end, but other spending also was fairly well restrained. At least until the past few years, the statutory caps helped to hold nondefense discretionary expenditures in check, and the pay-as-you-go rules forced careful consideration of deficit-expanding initiatives.[2]

The extraordinary rise in receipts over the past decade resulted from the exceptional performance of the United States economy and the associated rise in the market value of assets, which helped lift receipts from 17–1/2 percent of GDP in fiscal year 1992 to a postwar high of nearly 21 percent of GDP in fiscal 2000. The increase in receipts in the second half of the 1990's was particularly impressive—especially for individual income taxes, which grew about 11 percent per year, on average, be-

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[1] That projection would have indicated a need for significant accumulation of private assets in Federal Government accounts by 2009. In the actual CBO estimates of January 2001, that date was 2 years earlier.

In the absence of cuts in taxes or increases in outlays that are programmed and phased in well in advance, the avoidance of sizable private asset accumulation might require taking actions that would essentially eliminate the surplus as the Federal debt approached its irreducible minimum. As I argued a year ago, such actions could result in a fiscal policy wholly inconsistent with the state of the economy at that time. For reasons I discussed last January, I believe that cutting taxes is a far preferable way to reduce the surplus over time than to institute new expenditure programs.

CBO's projections of a year ago, which implied a substantial shortfall of reducible debt as early as 2007, suggested to me some urgency in phasing down the surplus. If CBO had access to the economic and technical developments of all of 2001 last January, it would have projected a somewhat later date for that shortfall. In the event, of course, a considerable part of the current-policy surplus was used to reduce taxes and to increase spending so that the most recent current-policy projections of the CBO do not anticipate a need for significant non-Federal asset accumulation until well into the next decade.

[2] Relatively favorable demographic trends helped to restrain spending on social security and health programs; and although health spending rose very rapidly in the first half of the 1990's, these outlays decelerated markedly in the second half as a result of both legislative actions and the cost-containment efforts in the medical sector.

tween 1995 arid 2000. The surge in individual taxes was attributable in part to the strong growth in incomes from production and to the tendency of rising levels of income to shift a greater share of taxable income into higher tax brackets.

But individual taxes also received a boost from the enormous rise in the value of financial assets during that period—directly through taxes on higher capital gains realizations and indirectly through the taxes collected from the exercise of stock options, from stock-price-related bonuses to workers in the financial industry, and from withdrawals from capital-gains-augmented IRAs and 401(k) plans.

Estimates based in part on data from the Statistics of Income and other sources suggest that such market-related receipts accounted for only about 15 percent of total individual receipts in fiscal 1995; but because they grew about 25 percent per year, on average, between 1995 and 2000, they accounted for more than one-third of the increase in total individual receipts over that period. Receipts that are more directly related to production in the broader economy—that is, those associated with wages and salaries, business and professional incomes, dividends, and interest income—rose 8–1/2 percent per year, on average, between 1995 and 2000, one-third the pace of receipts on stock-market-related taxable incomes.

Had equity asset values risen only as fast as nominal GDP between 1995 and 2000—that is, about 6 percent per year—taxes related to stock-price levels would have been approximately $130 billion less in fiscal 2000, even without taking account of the reduced receipts that would have resulted from a presumably less buoyant economy.

Recent developments, of course, have reversed part of this fiscal bonanza. Tax cuts, the weakening in economic activity, and the sharp decline in stock prices have reduced individual tax receipts. In addition, taxes on capital gains realizations have become an increasingly important component of corporate receipts in recent years—perhaps as much as one-fourth. Consequently, declines in stock prices have exerted additional downward pressure on corporate receipts, which had already taken a large hit from declining profit margins.

Increased funding for defense and homeland security and the higher expenditures on unemployment benefits and other cyclically sensitive programs are also pressing on our currentpolicy fiscal balances. Such calculations, of course, do not include the additional expenditures that doubtless will be authorized as the year progresses.

coming decade, though less favorable than a year ago, is still quite positive. CBO remains reasonably sanguine about the economy s growth prospects for the next 10 years, and this is reflected in the re-emergence in its current-policy projections of moderate unified budget surpluses by the middle of the decade. If realized, such surpluses, by lowering the publicly held Federal debt and freeing up private saving to be channeled into capital investment, would help us prepare for the considerable demographic changes that we face over the longer run. This will clearly be no simple task. As Dr. Crippen emphasized yesterday, the fiscal pressures that will almost surely arise after 2010 will be formidable.

Achieving a satisfactory budget posture will depend on ensuring that new initiatives are consistent with our longer-run budgetary objectives. Indeed, as you craft a budget strategy for coming years, you might again want to consider provisions that, in some way, would limit tax and spending initiatives if specified targets for the budget surplus and Federal debt were not satisfied.

The significant improvement in the budget in the 1990's reflected not only decidedly positive economic forces but also much hard work and many difficult decisions on the part of this committee and others. Similar efforts will be required in the years ahead.

Chairman CONRAD. As Dr. Crippen noted yesterday, we face a circumstance, where, instead of $5.6 trillion of projected surpluses over the 10-year forecast period, that has been reduced to $1.6 trillion. That is before the significant defense buildup that the President is apparently about to propose, or the additional funding for homeland security. Those initiatives will add hundreds of billions of dollars of cost that aren't in Dr. Crippen's analysis. We have many other things to address as well that are not included in those estimates. And yet even without those, we see that there are no surpluses without counting the Social Security Trust Fund. In fact, we see that we would really be running a deficit of $1.1 trillion over this period if we didn't have the Social Security Trust Fund money to fill in the hole.

And as Dr. Crippen noted yesterday, and as you have referenced in your testimony, we face a demographic time bomb because the baby-boomers are going to retired. And that is not a projection. That is not a forecast. Those people have been born, they are alive, and they are eligible for Social Security, they are eligible for Medicare. We know it is going to happen. And everything changes.

And as Dr. Crippen testified yesterday, we will face dramatic cuts in benefits or huge tax increases or massive debt or some combination if steps are not taken.

Yesterday, in our conversation you referenced the some $10 trillion of so-called contingent liabilities that are out there that the Federal Government faces, and you and I discussed how really most of that is not contingent liability. Based on the political realities, most of those are real liabilities, and yet we have not faced up to them.

In light of these facts, do you still believe that we should construct some type of trigger mechanism or some type of fast-track budget consideration to help build surpluses and more aggressively pay down debt?

Mr. GREENSPAN. I do, Mr. Chairman. I believe that we are going to be facing very significant problems after 2010, and while clearly that is a decade away, it is something which we have to be acutely aware of, because how we phase into that decade is going to matter as to how we finance it.

In separate testimony actually before this committee, which had a Social Security task force, I discussed the longer-term outlook for Social Security in terms largely not of looking at the question of the funding per se to which you referred, which is an important issue, but rather, to recognize that what really is involved here is a required level of economic output in the decade subsequent to 2010, which is adequate, one, to create a level of real resources which would allow retirees to retire with some dignity, but at the same time that allows those who are working to enjoy the benefits of rising productivity.

This means that we need to have a fairly robust rate of productivity growth in this country as we move off into the next decade, which means that fiscal policy, to the extent that that is going to affect what those productivity numbers are, has got to be focused on those policies which augment capital growth, capital spending. And, clearly, what fiscal policy can do in that regard, either from the tax side or from the government saving side, is to either create incentives for capital investment on the one hand or supply the savings that are required to be employed to finance it on the other.

And in that regard, in my judgment, the availability of some form of mechanism to fine-tune our longer-term commitments would be quite useful and, indeed, very important in this regard.

So I would suggest to you that since an ever-increasing part of the budget process is long-term commitments, we no longer have the luxury, which existed 30, 40, 50 years ago, where you would run 1-year budgets and you could change the next year's budget fairly dramatically. We no longer have that luxury. And as a consequence, it is quite important to make certain that there is a structure in place which creates the type of outlook which the Congress really intended.

Chairman CONRAD. Well, I thank you for that. I think that is a critically important point, and I hope people are listening, because if nothing else comes from this hearing, I hope there is a renewed concern about our long-term fiscal circumstance and what mechanisms we might put in place to foster the surpluses that are going to be necessary to meet these long-term obligations.

Can you tell us, when you mentioned last year some type of trigger mechanism, what did you have in mind?

Dr. GREENSPAN. Mr. Chairman, I didn't have any particular mechanism in mind, and the reason is that there are innumerable variations, all of which can do the same thing. In principle, I think it gets down to what the trigger is. Obviously, if it is some statistic or something which human beings cannot change, then you could conceivably build it into the law in which a particular program is going forward.

Chairman CONRAD. Should it be structured based on surplus levels or debt levels?

Dr. GREENSPAN. Well, there are lots of different types of triggers. My own view is it probably should be based on a level of the debt to the public. And I raise that issue because, as you know, Senator Hollings is using the other debt level, and I will raise the issue, as you have, that there is another level which relates to what he is suggesting, which is the contingent liability question.

Chairman CONRAD. And what are those contingent liabilities, as you see them? And how large are the contingent liabilities that we face?

Mr. GREENSPAN. Let's remember what they are. If you create an accounting system which, rather than measures the benefit payouts at any particular time, endeavors to determine what is accrued—what the Federal Government under the code of law and reasonable expectations about long-term real wage growth will be—that creates an obligation on retirement and that number, that actual liability, whether you call it contingent or non-contingent, is created currently. At the moment and for recent years and for a certain period ahead, accrued liabilities are higher than the benefits being paid out, and that is accumulating a debt.

If you believed that the existing law will never be changed and, indeed, can't be changed, then it is no longer a contingent liability. The reason it is contingent is that the Congress can, with majority vote, alter benefit payments in the future.

My own impression, having lived with this program for a very long period of time, is that the probability of a significant reduction occurring in those benefits over the long run is not very high, which means that the very large proportion of the contingent liability, as you pointed out, Mr. Chairman, is not really contingent in any realistic sense.

I understand, for example, in the Federal Government's balance sheet we assume only 1 month's liability on Social Security benefits on the presumption that you can change it in 30 days and eliminate the program. Well, I wouldn't want to bet the ranch on that.

Chairman CONRAD. I wouldn't either, and $10 trillion is approximately the——

Mr. GREENSPAN. That is correct, sir.

Chairman CONRAD [continuing]. Current contingent liability.

Senator Domenici.

Senator DOMENICI. I am going to let Senator Hagel take my turn now, and I will get back to it in due course.

Chairman CONRAD. Very well.

Senator HAGEL. Thank you, Senator. Thank you, Mr. Chairman.

Chairman Greenspan, welcome. In your testimony this morning, you said, and I quote, "The retrenchment in capital spending over the past year was central to the sharp slowing we experienced in overall...activity." In light of that fact, in light of the current Enron investigation, auditors' relationships with their clients, and all the other dynamics that factor into that equation, I would expect to see—more importantly, I would like your opinion on this—that as companies scramble to clean up their balance sheets, take losses, get some of the bad news out of the closet, being concerned if for no other reason that they will be hauled before a committee next, questioning their auditor relationships, I suspect that does not produce a particularly viable atmosphere and market for formation of capital and the application of that capital to invest.

And when you look out across our global economy and see that the world economic situation is not particularly stable, and you factor in that foreign investment in our stocks and bonds in the year 2000 reached about, I believe, half a trillion dollars, we have some rather immense challenges.

I would like you to come at this in any way you would like. Are you concerned about that, at how that projects itself into growth over the next two or three quarters, maybe all this year? Also, if we are to do an economic stimulus package, then should we be focused in that economic stimulus package with economic stimulus measures like investment measures for business?

Mr. GREENSPAN. Senator, I think you are raising a very important point, and, indeed, it could come out the way you suggest. I am actually increasingly inclined to take a somewhat different view. I am surprised, as I suspect most of us are, at the extraordinary interest that has been devoted to this particular episode. And I think it is a very good sign. It tells us that because the whole structure of American business is so fundamentally based on trust, that any evident abrogation of that trust creates a real furor, which it should.

Think of the worst outcome, namely, that we went through this particular episode and nobody cared. I think there are other places in the world in which an episode like this would be shrugged off as normal business. This is not the case. It is essentially telling us that we are not an economy which takes erosion of reputations as a minor question. Indeed, I think one of the lessons that people should learn is that Enron, without a considerable amount of physical assets, created a very large market value on its reputation and its conceptual skills. And that is a very fragile evaluation.

Reputation is something, unlike a petrochemical feedstock plant which cannot disappear overnight and its value will not disappear very quickly. Fifty years ago, we used to have steel complexes and motor vehicle assembly plants, and that is what the major part of the value of those firms were. The conceptual value, the managerial strengths, and the like, were important but they were a part, only a part of what the market value of those firms were.

We are increasingly getting firms which are conceptual, and Enron is a classic case, whose value depends increasingly on reputation and trust. And if you breach that, that value goes away very rapidly. And I frankly find that the remarkable reaction to this event suggests to me that people realize that trust is such a crucially important issue with respect to transactions which we all have every day. And we deal with each other in an essentially honorable way, because honesty is a very important economic value, as is trust, and we capitalize it on our balance sheet and call it goodwill. And I think that an abrogation of that good-will clearly has happened in some form or another. And I don't know what the facts are and won't know until all the hearings are out of the way, but an abrogation of that has been taken very seriously by the American public, and I think that is very good.

Senator HAGEL. If you would respond to the second part of that question, economic stimulus package.

Mr. GREENSPAN. The stimulus issue is a difficult one at this particular stage because, while three months ago it was clearly a desirable action in the sense that an insurance taken out for an economy which clearly had not found its legs in any respect whatever, was, I thought, a desirable thing. We didn't do that. Fortunately, it turned out that we didn't need that particular insurance. But looking forward, it is not clear that we might need that insurance.

In my prepared remarks, I pointed out that the usual surge that we get after an inventory reversal in recessions of the past is unlikely to be as vigorous as it was in the past, largely because the household sector, which has been so important, did not go down as much in this recession. And so it is conceivable that we may need some additional stimulus, which would be helpful, coming into effect in the spring or the summer or something of that timing.

I myself am conflicted on the issue. On the one hand, I am looking at the fact that we do have a budget which is very close to balance, and any stimulus program will clearly put us into deficit and go in the wrong direction that we were talking about.

Second, any temporary stimulus program by its nature does distort the capital structure of the economy. If you are dealing with an issue where the economy is weak, very clearly stimulus programs are highly desirable to have, and they are important, even though they have negative long-term effects. But at the moment, I have not come to a conclusion on this particular one, and I think whether we do it or we don't, we have pluses and minuses.

I do not think it is a critically important issue to do. I think the economy will recover in any event. But nor do I think that a temporary stimulus program, which, by definition, will phase out, is a long-term threat to the budget itself.

Senator HAGEL. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Hollings.

Senator HOLLINGS. The trust you talk about, that is why I am disturbed with respect to this committee, because we are charged with the responsibility fiscally, and there isn't any question to start this consumer confidence, as you pointed out and as the chairman emphasized—I didn't know we were going to have this here, but all else being equal, a declining level of Federal debt is desirable because it holds down long-term real interest rates, thereby lowering the cost of capital, elevating private investment, and so forth.

Now, you have done everything on the short-term interest rates, 11 cuts in 1 year. But we have done absolutely nothing with respect to just that, the long-term, because—I said it yesterday—we act just like Arthur Andersen in our accounting. And it is not a laughing matter because here is what you do, Mr. Chairman.

Mr. GREENSPAN. It is not.

Senator HOLLINGS. You call a budget—you just said it, a budget close to balance. We ended up with a deficit of $143 billion this last year, $143 billion deficit. That was as of September the 30th. We only had 9/11 just 20 days ahead, so we didn't spend $143 billion. I mean, the economy was going down, it had been going down, and everything else like that, and we were continuing to spend. And the real devil in the details is this public debt and private debt specifically.

While you talk about the public debt going down, the overall debt goes up, the Government debt, rather, and, of course, the overall debt. In other words, I have in my hand the CBO report, and yesterday that is why I called us the sort of Arthur Andersen, because we were only discussing surpluses. This document that the committee discussed yesterday, the budget and economic outlook for the fiscal years 2003 through 2012, only talked about surpluses. They didn't talk about the deficit and the overall net figure. And the overall net figure went up, up, and away some $2 trillion.

That is the course that we are on, and that is the way your Wall Street market looks at things. They look at the reality. If it is going up $2 trillion, the Government is going to be coming into that market with sharp elbows, as you say, at least holding the long-term interest rates up, and that is what has happened here over the past year, even though you have cut, cut, cut. And the long-term interest, 1.7, I think it is 5.4 or 5.5, it is almost a full point spread in there. Isn't that the case? Isn't that the market—what the market is saying, they are not going along with this public debt/private debt. They are looking at over the net amount as to whether or not the Government is coming into the market to borrow.

Mr. GREENSPAN. Well, Senator, I agree with your general overall approach. I don't agree with the particular accounting. As you know, over the years we have argued on this issue. The difference between us, as I think I reiterated last year, is that I would focus on the debt held by, the public; this does not include the debt held by the Social Security Trust Fund which is intragovernmental debt and part of the numbers to which you are referring.

Senator HOLLINGS. And that is the contingent liability.

Mr. GREENSPAN. No, it is not. It is only a very small part of it. And I am suggesting to you that—the reason I agree with your broader question is I tend to add the $3.75 trillion, which is the debt directly to the public, to the $10 trillion, or $10 trillion less whatever the contingent would be, rather than add the amount of Treasury debt securities held by Government agencies, which, in my judgment, is the equivalent of intracorporate debt transfers, and in the consolidation they wash out. But the contingent liability does not wash out. And, indeed, the concerns that I think the markets have increasingly is that, as you move into the next decade, when those contingent liabilities are turned into actual debt to the public because you have got to cash them in. Then, I think you have got some real serious problems.

Senator HOLLINGS. But the actual—Mr. Chairman, I would ask unanimous consent that I include in here the table at this particular point.[1]

Chairman CONRAD. Without objection.

Senator HOLLINGS. The table I refer to has Social Security, Medicare, military retirement, civilian retirement, unemployment, highway, the airport that we owe those particular trust funds. And we right now owe Social Security as of this particular chart, a CBO figure, $1.5 trillion that we have spent.

I remember Section 14 of the Greenspan report of 1983 that says put it off budget and don't spend it. And we passed 13–301 in 1990, and we had Bush, Sr. sign it. And it is law, but it is disobeyed. But that contingent liability goes to $2.8 trillion, and I had it down here in a figure a minute ago. It is up to $6 or $7 trillion—well, it is up to $6 trillion. You will owe Social Security by 2012 $3.8 trillion. That isn't any contingent. That is just the actual owing. And the overall, all of these trust funds, I $5.9 trillion. So that is the thing when you borrow from all of these particular funds, it is like borrowing from your American Express to pay your MasterCard. You owe the same amount of money. And owing the same amount of money, namely, the debt going up over the next 10 years, it is going up some few trillion dollars. The gross Federal debt goes from 5.7 to 6.7, just about—no, it goes from 5.7 to 7.6. It is 1.9.

So that is what I am—I am going with you, I am going with the Chairman, and that is the thing that has bothered me as we get this double talk about deficits and surpluses. And yesterday we had nothing but talk about surpluses, and the debt is going up, up, and away, and we are having to continue to borrow. Isn't that correct?

Mr. GREENSPAN. Well, let me tell you where the difference——

Senator HOLLINGS. Is that correct or not? Am I saying something that is stupid?

Mr. GREENSPAN. No. I am just basically saying that you——

Senator HOLLINGS. Is the debt going up in the——

Mr. GREENSPAN. I am saying the number——

Senator HOLLINGS. Let me ask you this. Here is the CBO report. Does it project that the debt goes up and the Government will have to borrow over the next 10 years or not?

Mr. GREENSPAN. It does, and it——

Senator HOLLINGS. It does.

Mr. GREENSPAN. But wait a second. It is an underestimate of what is going to have to happen in the sense that the Social Security Trust Fund is not fully funded, meaning the total quantity of assets which are held in the trust fund are a small fraction of what a private insurance company would require to fund the same obligations.

So I am not disagreeing with you. I am just saying basically that the numbers that you are using are not the numbers I would use because they are intragovernmental transfers, and what you want

[1] Information not available at press time.

are the full funding numbers because they tell you really what the Federal Government is going to have to borrow. Those numbers are incomplete and largely incomplete because the trust funds that are built up in Civil Service, and Social Security, are based on a particular tax——

Senator HOLLINGS. Doctor, what about a target of a budget freeze? We just passed all the budgets last month, the major ones, just signed by the President. Why not take those budgets agreed upon for next year, save and excepting defense security and home security? We can all agree and sort of limit the yin-yang that goes back and forth and the politics and everything else like that, and then really debate out what more is needed, if so, in defense and home security. What about that kind of target?

Mr. GREENSPAN. Senator, if I were an elected official of the United States Government, I would answer that. But I am not.

Senator HOLLINGS. Well, you answered all the other targets.

Mr. GREENSPAN. No, but you are asking——

Senator HOLLINGS. You have given me an affirmative answer. Thank you, sir.

Chairman CONRAD. Senator Smith.

Senator SMITH. Thank you, Mr. Chairman.

Thank you, Chairman Greenspan, for being with us. In your testimony you noted the CBO reports that last year projected over 10 years a surplus of $5.6 trillion, and that in a year's time that surplus that is projected has fallen by $4 trillion, leaving over 10 years a surplus of $1.6 trillion.

Now, I assume that is the accounting method—if you agree with this, you are using the accounting method that we are all assuming and not the one that Senator Hollings is talking about. My question is: If there is a $1.6 trillion surplus, that assumes, does it not, that there will not be any increases in spending or changes in tax policy? Is that correct?

Mr. GREENSPAN. That is correct, Senator.

Senator SMITH. Sir, my experience only 5 years as a United States Senator is that there is on the Democratic side a reluctance to roll back the tax cuts, on the Republican side not very much will to resist spending increases. I have come to that conclusion because there doesn't seem to be much penalty around here for lowering taxes or increasing spending. In fact, that is how you are politically rewarded. So I guess what I am saying is I am not real optimistic that these policies are going to hold if what I have seen here the last 5 years continues.

But if that is the case and we are now debating a stimulus package, you have testified this morning that retrenchment in capital spending over the past year was central to our economic slowdown. You have specifically cited that new orders for equipment and software, information technology, fell dramatically last year and that that is the reason why we are experiencing such a dramatic slowdown. Now I am going to ask you a tax question. As we debate this stimulus package, is there something we should be doing or considering with respect to depreciation schedules, specifically on high-tech equipment, to help to get that sector going again? Because you have said specifically in most cases businesses required that new investments pay off much more rapidly than they had previously. Should that be something we should be considering on the tax side?

Mr. GREENSPAN. Well, Senator, if you are going to consider a short-term stimulus package, meaning something which has major loss in revenue up front and in a certain sense almost reversing as you go farther out, then a temporary acceleration of depreciation, either by actually changing the codes, which are very complex, or far more preferably, expense, say, a portion of capital outlays for a year or two, what that will do is create a presumed moving of expenditures from a subsequent period up front. In other words, you will very unlikely change the aggregate amount of capital investment over a period of time. You will just displace it in time. And, indeed, if your purpose is short-term stimulus, that is exactly what you want to happen.

It is not, however, a long-term stimulus bill, and, indeed, as I said earlier, it is very likely that all short-term stimulus bills probably have a modest—not an important but certainly a modest negative effect over the long-term outlook.

Senator SMITH. Because they just move consumption earlier as opposed——

Mr. GREENSPAN. They move it, exactly. And they move capital assets sooner than they otherwise would have been.

Similarly, the types of tax policy which would enhance long-term capital investment are wholly different from the types of actions you would take for short-term stimulus. And, indeed, by definition, they have no short-term effects.

So it is a choice of what you are trying to do, and I find mixing the long term and the short term is an ambiguous policy in that regard, and then trying to figure out how it works is extraordinarily difficult.

Senator SMITH. But at least I think what I am hearing you say is that for our purposes, we ought to be looking on what makes the most sense long term in terms of depreciation schedules in order to foster a healthy, reliable business climate.

Mr. GREENSPAN. Senator, if you are going to think long term, then you think permanent, not temporary changes. And permanent will not have significant short-term effect. Indeed, it will have some effect, but what really causes a 1-year, for example, say, 30 percent writeoff of capital investment is you move investment from 2 and 3 years out up into the first year, and that will enhance capital investment and boost the economy in the short run, but it will be at the expense of the economy in the second and third year out, and over the 3-year period probably it is a small negative.

Senator SMITH. OK. Mr. Greenspan, I need to ask you a spending question. We are going to do a lot more on winning this war and protecting our country and homeland defense. Another priority of mine and my colleague Senator Wyden is with respect to the uninsured. We have a terrible—I am talking about medical insurance, the working uninsured of this country who fall through the cracks in our system and continually are resorting to get health care at the emergency rooms of our hospitals, and providing a very inefficient, very expensive way to receive basic medical care.

A concern I have is that we not lose focus of this, perhaps looking for ways to incentivize businesses to provide more to employees, in some way giving them the incentives to make it available, and then employees to be able to afford their portion of it.

I think another component may well be expanding our community health centers, and I am wondering if you have seen a model out there, something short of what Europe has, something more than what we have, that can more efficiently provide health care to our country and close this terrible gap of 40 million Americans without health insurance.

Mr. GREENSPAN. I must say, Senator, even though it is not something that I have time to spend a good deal of time on, it is a subject which does interest me, and, indeed, I think having been involved with the Social Security Commission almost 20 years ago, inevitably we got involved in health problems and the structure back then, which is not all that different from the types of questions which arise today.

I have not in my own mind found a simple way to convert what is the extraordinary medical technology which we have developed in this country into a functioning medical system. I know in many respects we perceive ourselves as not doing what other countries do. Our morbidity and longevity is not significantly different from those who spend very substantially less of their gross domestic product on health care. But it is very difficult to know why that is, in any meaningful way, and it is a subject matter which I must say I find very difficult to get conclusions where I am comfortable I would know how a model would turn out.

I have struggled with it, and I can't say I have come up with something which I find useful.

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

Chairman CONRAD. Let me just make the observation that we have six questioners left on this side, we have eight left on this side, and on both sides we have been going over the 7 minutes by a minute and a half or so because of the seriousness of the questions. Nobody has been imposing on a colleague's time, but I think maybe we are going to have to cut it back to 5 minutes of questioning and statement time, or else people are just going to get left out here today.

Mr. GREENSPAN. I will shorten my answers considerably, Senator.

Chairman CONRAD. If you could, that would be helpful as well. I appreciate that.

Senator SARBANES. That is an extraordinary contribution. [Laughter.]

Chairman CONRAD. Senator, we had indicated to the Chairman that we would seek, endeavor to be done at 12:30. That is the deadline that we are working against.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Chairman, when you spoke January 11th in San Francisco, stock prices fell pretty sharply during your speech. And in the days after January 11th, various Fed officials went out and said that those comments were misinterpreted. Newspapers carried headlines all over the country: Fed Chairman has been misinterpreted.

I think it would be helpful if you could characterize today how you do see the economy. I don't want to try to lock you into a simplified debate about isms, whether you are showing pessimism or whether you are showing optimism. I think it would be helpful if you could clarify the message from January 11th, and obviously there was some concern from the Fed that day, and let me ask that to start with.

Mr. GREENSPAN. Well, Senator, I tried to address that issue in my prepared remarks, and you will find that a considerable amount of what I had to say is quite repetitious of the speech I made in San Francisco.

It is very difficult in giving any speech of, say, 20 minutes, 25 minutes, to capture a particular view at a complex time such as this. What I was trying to do in that particular speech was to look at the American economy, which had been battered very brutally if I may put it that way, one, by a very sharp contraction in the rate of growth and fall in capital investment, profits, stock prices, and the like, and then, followed up in September with a tragic set of events, which in the past I would have suspected would have breached the underlying confidence both in the consumer and household sector and created a really serious, deep-seated problem for us.

In the event, it didn't turn out that way. It turned out that we showed a far greater degree of resiliency and flexibility, and the economy stabilized. And I was trying to make that point without trying to get to an issue of whether we were going to snap back quickly or not so quickly. The markets, however, have been assuming a far more rapid snapback than I frankly think is likely to happen, largely because we haven't gone down very far. And that created, unfortunately, I think, phraseology which in retrospect I should have done differently, which sort of implied that I didn't think that the economy was in the process of turning. And I tried to rectify that in today's remarks.

Senator WYDEN. Let me ask one other question. My State has the dubious distinction now of having the highest unemployment rate in the country. People are really hurting, and I have said for purposes of this session that I am going to measure everything in terms of how much it will do to create good-paying jobs and how quickly.

Tell me conceptually, because you can't get into the merits of legislation, what your reaction would be to having a tax credit for businesses that hire workers, particularly displaced workers, someone who has been laid off. Conceptually, how would you assess that?

Mr. GREENSPAN. It depends on whether you are thinking of it in terms of something to help those individuals who are in very dire straits or whether you're looking at it as an economic program. In my judgment, it is the former not the latter, because you cannot reverse cause and effect, so to speak, in an economy. Economic activity creates jobs. It is not the other way around. And, therefore, I would say that if we are interested in getting the unemployment rate down, what we have to do is to increase the rate of growth in output.

Senator WYDEN. One other question, if I might. I heard a lot of concerns in Oregon last week about our policy with respect to the dollar, and the concern was that our policy on the dollar was hurting Oregon companies, United States companies, in terms of being able to cap export markets. In our part of the world, one out of six jobs depends on that kind of export opportunity, and they pay well.

Do you have any thoughts about what kind of policies would be appropriate with respect to the dollar so as to get the most opportunities for United States businesses to get more exports overseas?

Mr. GREENSPAN. Senator, those of us who are involved in financial policy in the United States Government are acutely aware of the fact that we can only have one voice on exchange rate policy, because if you get a number of people or a cacophony of people talking about it, it would tend to undercut markets. So the Secretary of the Treasury has been our designated spokesman, and I have tried to adhere to not commenting on the issue of the dollar. And I hope that that policy over the years is to work to our benefit. I suspect it has.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. And, Chairman Greenspan, it is good to hear from you again.

A couple years ago, you cautioned the Congress about irrevocable or almost irrevocable programs that were being put in place, and I heard in your comments today kind of a reference to continued concern in that regard. And then yesterday we heard from the Director of the Congressional Budget Office, Dan Crippen, who testified before this committee that since January 2001, Congress has increased discretionary spending to the tune of $44 billion in 2002, $49 billion in 2003, and over a 10-year period, a total up to about $550 billion.

I would like to have you share your opinion on the long-term risks involved in continually increasing discretionary spending, and then I have a second question.

Mr. GREENSPAN. Senator, I think if there is one lesson we have learned from these most recent experiences, it is that while caps on discretionary spending actually work remarkably well in periods of deficit, they do not in periods of surplus. And, indeed, it is very evident that as the deficits turned into surplus, those caps eroded very rapidly. And I would hope that when the expiration of the existing caps, which is this September, occurs, that the Congress will be able to extend them and, indeed, trust that they work as well as they did in the past. I suspect they have a good chance of doing so, and I would think that that to me would be the best program that one could focus on to constrain the type of numbers you are talking about.

Senator ALLARD. Second question. I would like to hear your comment on creation of new programs and more spending as a stimulus for the economy as opposed to tax cuts. And, more specifically, is this an appropriate time to consider reducing the capital gains tax even further because of its potential stimulatory effect on the economy?

Mr. GREENSPAN. Well, Senator, as I have testified—I didn't realize it was 18 times, but I think you will find the one consistency through those 18 appearances is that I have always stipulated that I thought that if long-term fiscal balance is the basic purpose, that one should focus on holding spending down, and if you run into available surpluses, to try to remove them by reducing taxes. So I would say basically I would be mainly focused, as I have in the past, on that issue.

Senator ALLARD. Comment a little bit on capital gains, if you would, please. We look at increased revenues——

Mr. GREENSPAN. Yes, I have in the past argued that the capital gains tax is in my judgment an inappropriate means to raise revenue because its effect on the capital stock is very substantial, and that there is a big dispute within the economics profession because it is very difficult to actually make a determination whether the statement I just made is true.

Having worked in the business arena for most of my life, I am convinced that it is. I think it is far better to raise revenue by other means. So I have always been in favor of eliminating the capital gains tax. Obviously, reducing it is preferable to not eliminating it, so I would always be interested in moving in that direction.

If it turns out that you need revenues—if it creates serious fiscal problems, then I would argue pick up the revenues by another means.

Senator ALLARD. Mr. Chairman, I see I am going to turn back 30 seconds for my colleagues.

Chairman CONRAD. You are a hero. [Laughter.]

Chairman CONRAD. Senator Murray.

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

Thank you, Chairman Greenspan. It is an honor to see you here again today, and I just have to say, before I ask you a question, that it is amazing what a difference a year can make. I remember sitting in this committee a year ago when we were looking at surpluses and we had estimates showing that we would be able to buy down the publicly held debt by 2009, that we could strengthen Social Security and Medicare, that we could return a significant portion of the surplus to the taxpayers, and we were told that based on 10-year budget projections that we could have it all. And I remember cautioning every member of this Budget Committee to be very careful because what I saw happening in my own State a year ago I felt would soon be seen by the rest of the country.

At that time we were facing a major energy crisis, as the entire West Coast was. We were worried about increased costs for all consumers in terms of energy and job loss. And I warned our comrades about that as we began the budget discussions about having a huge tax reduction at that time.

And many of those predictions that I was concerned about have come true in my State. We have had tremendous job loss, especially in any industry that has high energy costs. Our aluminum companies, our cold-storage facilities have been shut down. Many of our small communities have high unemployment rates right now as a result of that—and that was before the effects of September 11th—on the aerospace industry that sits in my State, and 30,000 Boeing employees are now being laid off.

We have the second-highest unemployment in the Nation right behind my neighbor Oregon to the south, as Ron Wyden alluded to.

Consumer confidence in my State is very real. People are very concerned about whether they are going to keep their job or not. The dotcom industry has had a tremendous impact in all of our region. Our farmers have not been able to sell their products in Asia, which has been the market that they have counted on.

So consumer confidence is way down, and I am extremely worried about that because everyone I know knows someone who has lost their job or has been given a pink slip.

As we talk about this economic policy that we are—stimulus package that we are debating here in the Senate, I hear a lot about the stimulative impact of a tax cut and the debate on both sides of that. But I think it is also important that we deal with the consumer confidence. Extending the unemployment benefits, taking care of those people who have been laid off, who are concerned that they can't pay health care, establishing that kind of confidence that if you are laid off, that you won't be emptied of your bank account, that you will be able to hold it together for a while until things get back on track is very important to people in my State and I think across the country.

What do you think of the stimulative effect of us making sure that those who have been laid off have extended unemployment benefits or health care coverage while they are out of work?

Mr. GREENSPAN. Senator, I have always been in favor of extending unemployment benefits during periods of rising unemployment, largely because the purpose of having the 26-week limit, which is standard, is essentially not to get people involved in long-term unemployment insurance as an alternate to work. And, indeed, it works exceptionally well when the job market is functioning normally, but, clearly, you cannot argue that for somebody who runs past the 26-week level it is because of sloth or not looking for a job or not actively seeking to get re-employed. There just are no jobs out there.

Consequently, to adhere to the 26-week limit doesn't serve its actual purpose, which is essentially to prevent a misuse of the unemployment insurance system. So I have always been in favor of extending benefits when the job market itself begins to dry up.

Senator MURRAY. And the health care? Because that is an out-of-pocket expense that most people cannot afford.

Mr. GREENSPAN. Well, I don't want to get into detailed general budgetary questions. Those are issues which I try to avoid if I can, and——

Senator MURRAY. But you would agree that consumer confidence in their ability to survive tough times is an important part of economic recovery?

Mr. GREENSPAN. I would say consumer confidence in general is clearly important, and the source of consumer confidence is broadly determined by an expectation that the economy is improving, that job prospects are favorable, that one can function and plan in an economy in which one is not concerned about losing one's job.

Senator MURRAY. Thank you. And the other fear that I see now, for the first time in my life, is people's fear of retirement. That has been fueled by an Enron scandal that means people don't believe or are fearful that their pensions may not be there. They hear about a budget deficit here, that the long-term prospects for Social

Security and Medicare will be impacted by that. We still have the whole issue of prescription drugs that are an increasing out-of-pocket expense for senior citizens who aren't covered. And for the first time, I am hearing people who fear retiring. It is an issue of confidence that those protections will be there. And as we talk about now coming to a point where we have a budget deficit, from your point of view can we still protect the solvency of Social Security and Medicare? And how important is that as we look at our budget?

Mr. GREENSPAN. Well, Senator, it depends on how one looks at those programs. I don't believe that, in the event that the Social Security Trust Fund were to go to zero, which would require a delay in the payments for Social Security, that it would ever actually occur in that sense. In other words, I don't believe that people really have need to be seriously concerned about getting Social Security benefits, because in my judgment I do not think that there is any likelihood that should the budgeted resources currently in place, which is essentially the Social Security Trust Fund, run out, that the Congress would allow benefits to somehow be altered in a significant way.

I consider there are certain types of things we have in Government which are structures which will never be employed, and that particular rule, in my judgment, will never be employed.

Senator MURRAY. Well, I would agree that the social conscience of the Senate would make it difficult for us to not do that, but I do think we have to look at it, Mr. Chairman, as part of what we have to protect in our budget as we move forward.

Chairman CONRAD. Thank you, Senator.

Let me just say we are doing a little backsliding now on both sides. So if we are going to stay on for 12:30, we have got to try to be closer.

Senator Snowe.

Senator SNOWE. I realize the pressure is on, Mr. Chairman.

Chairman CONRAD. Follow the example, the Allard example.

Senator SNOWE. I will try.

Chairman Greenspan, earlier in response to the chairman's question regarding a trigger, you outlined some of the benefits that could be accomplished by such a mechanism. In fact, I recall a year ago you, in fact, suggested it in your testimony to this committee. Actually in response to that suggestion, Senator Bayh, Senator Stabenow, and I and others worked in a bipartisan fashion to establish a trigger that would tie spending and tax cuts to get reduction targets, and it would kick in in 2004. So even with this recession, it wouldn't send, I think, the wrong message and kick in. It would be forward-looking.

Do you think it makes a difference in how we structure this type of trigger?

Mr. GREENSPAN. Not really, Senator, so long as it accomplishes its goal. The principle I would apply here is to be certain that there is a judgment of the Congress involved in the implementation of the trigger, unless you can find a trigger which is unrelated to policy decisions. In other words, you cannot, for example, make a CBO determination an automatic trigger on any program of the Federal Government, or put more exactly, you shouldn't.

If you are going to do it—some States, for example, have triggers which effectively are determined by actual events within the State which are not subject to political manipulation—you have to be careful to be sure that something like fast-track would be the model I would think, if you are looking at a budgetary issue. You can't use a trigger in which something happens without the Congress doing something. But I do think that what a trigger ought to do is enforce that action be taken and probably be an up- or down-vote of a certain type, in a similar type of legislation, but not exactly, as fast-track. And the crucial issue there is to make certain that the rules of the Senate and the rules of the House are employed in such a manner that they come together at the right—I should say approximately the same time.

Senator SNOWE. I see. So, in other words, that Congress obviously should be in a position—you have a mechanism in place so that Congress has to take a proactive action on such a trigger. You know, so if we have to suspend either spending or a tax cut that may be kicking in in the next year, that the House and Senate would both have to take that action.

Mr. GREENSPAN. Correct.

Senator SNOWE. Vote on it. OK. Thank you. That is helpful.

Last year, you mentioned that a tax cut may not prevent a recession, but it could lessen the impact or shorten the direction. You know, a tax cut could be helpful in that sense. Do you think that the passage of the tax cut at the end of May in the Congress had any role at all potentially in shortening the duration of this recession and mitigating the impact of this recession?

Mr. GREENSPAN. I think it did, Senator. I think that the evidence of consumer markets in August and even early September was that there was some impact of that. Obviously, with September the 11th, the whole situation changed very dramatically, so it was very difficult to trace the effects after that. But from what I could see, it did have an effect.

Senator SNOWE. You mentioned that an economic recovery obviously is going to happen in any event. I think the real question is: What type of recovery? And one of the major concerns that we all have, of course, is this unemployment rate. So we could emerge from this recession and yet the effects could be benign because of the unemployment rate, and that that could continue to rise or jobs not created that will help those who have lost their jobs.

So do you think a stimulus package of some kind could help to really turn around the behavior of this economy so it could mitigate those effects sooner rather than later?

Mr. GREENSPAN. Well, Senator, I did respond to that question earlier and concluded that it is very difficult to judge. Clearly, as you point out, with the potential at least that the economy may be more tepid than we would like, later in this year some form of stimulus program probably would be useful. But we don't know that yet. In other words, it is very difficult to judge exactly how this year is going to develop. I think we do know—one of the very few things that economists know—is that inventories cannot get below zero. And that may seem like sort of a simplistic statement, but it does mean that inventory liquidation, which has been very large, must slow its rate of pace, meaning production must rise relative to consumption.

But once you go beyond that, it is difficult to read the signals. It could go either way. And if the judgment is that it is going to be softer than the Congress would like, clearly a stimulus program would be helpful in that regard.

Senator SNOWE. Thank you.

Mr. GREENSPAN. But I am not sure how one could argue either side very effectively.

Senator SNOWE. Thank you.

Mr. GREENSPAN. Unqualifiedly, I should say.

Senator SNOWE. I appreciate that.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. And thank you, Chairman Greenspan. As I said last year, I am always very impressed with your testimony.

Mr. GREENSPAN. Thank you, sir.

Senator BYRD. I wish we had more time, but I can understand the time constraint.

This year promises to be a very difficult year for the budget and appropriations process. The projected return to deficit budgeting, the recession, the midterm elections, and the demands for increased homeland security and for supporting our military have left a very dark cloud looming over the entire budget process this year.

The political cross-fire that we have seen so far will only serve to exacerbate the tensions between the two political parties and between the legislative and executive branches. Make no mistake, I am no supporter of the tax cut that we passed last year. I was one of its most vocal and fiercest opponents. My wife and I returned our rebate to the Bureau of Public Debt.

But the reality of the situation as I see it os that today's political environment does not allow at this time for the repeal or delay of the tax cuts we enacted last year. That is not to say that some future Congress or President will not want to or have to revisit last year's changes to the tax code. It simply means that it is highly unlikely that the 107th Congress and this President will do it.

And anybody who knows anything at all about the Senate rules knows that to be the case, and the President can say, "Over my dead body," to use his euphemistic approach, will they increase taxes. He can say that because it takes 60 votes in the Senate to pass such legislation repealing last year's tax cut. Sixty votes. The Democrats, if they all voted together, wouldn't have but 51 votes. So he can be sure that his body will not be dead and that the repeal of that tax cut will not be enacted, this year at least.

What is more, it does no good to advocate unrealistically low spending levels that nobody expected to be enacted. It sets up a game of chicken, with the loser being the one who thinks he is first and admits the reality that spending levels have been set unrealistically low.

I can see the handwriting on the wall. With the rhetoric that we have heard so far from the legislative and the executive branches, we are setting the stage for months of wasted time, feuding over proposals that have no chance of becoming law, and eventually will result in an omnibus bill at the end of the year, and that is a prescription for overspending.

We need to focus our efforts on crafting a budget resolution that is practical and realistic in its assumptions about tax cuts and spending. Anything else only serves to exacerbate the contentious atmosphere that already surrounds this year's budget and appropriations debate.

So with that said, Chairman Greenspan, I suppose you would agree that unnecessary delays in the budget and appropriations process, like we saw last year, is a negative overall for the economy.

Mr. GREENSPAN. I agree with that, Senator.

Senator BYRD. Second, under the Budget Act, reductions in taxes and increases in mandatory spending are supposed to be paid for. And yet, over the last 3 years, over $160 billion of tax cuts and mandatory programs expansions have been wiped off the so-called pay-as-you-go scorecard. So there is a free lunch without that scorecard.

In your testimony, you indicate that Congress should consider mechanisms that would limit tax and spending initiatives. Do you believe the pay-as-you-go provisions of the Budget Act should be extended?

Mr. GREENSPAN. I very much do, Senator.

Senator BYRD. Mr. Chairman, I am getting clear answers to specific questions.

Senator SARBANES. It is a miracle. [Laughter.]

Senator BYRD. Miracles do happen.

Now, Chairman Greenspan, there has been talk here about trigger mechanisms, and Mrs. Murray raised the question with respect to Social Security as to whether or not there would come a time when the expected recipients, and especially those in the baby-boom generation, can look forward to receiving their check. I am paraphrasing it, changing it a little bit.

Would the long-term problems facing the Social Security and Medicare system justify the trigger mechanism you mentioned in your testimony?

Mr. GREENSPAN. You mean actually having triggers on benefits and the like? I am sorry. Is that the——

Senator BYRD. Well, I am wondering if the long-term problems facing the Social Security and Medicare system justify a trigger mechanism that you mentioned in your testimony last year as well as in this year. We are all concerned about Social Security.

Mr. GREENSPAN. I am sorry. I don't understand. Triggers can be on specific programs or be more generic. Are you referring to a trigger on the Social Security program or the broader trigger to protect Social Security?

Senator BYRD. I think I am referring to the broader trigger.

Mr. GREENSPAN. I do think that because so much of the Federal budget, as you know, has become nondiscretionary, which we used to call "uncontrollables," that it is very important that we have a mechanism which enables the trend of receipts and outlays to match the goal of the Congress over a period of years. Since unlike, as you may recall, 40 years ago when you could pass 1 year's appropriations and do something wholly different the next year, because you didn't have a lot of continuing programs going on—because we don't have that, I think something of the nature of the trigger probably will ultimately turn out to be essential if the Congress is going to try to guide where the long-term fiscal programs are going to go.

Senator BYRD. Mr. Chairman, I would like to ask one more question.

Chairman CONRAD. Go ahead. You didn't have an opportunity yesterday. You waited very patiently. Please, go ahead.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Chairman, Dr. Greenspan, I strongly supported new money for homeland defense last year, and I would have utilized more of our resources for that purpose. The Administration opposed going beyond the $40 billion overall that we passed in the supplemental, of which, in the last $20 billion which was to be included in the last appropriation bill, and was, I sought more money for New York and for homeland defense. As I see it, there is no difference in homeland defense and defense in the usual sense. Homeland defense is something new, but it is defense. It is the defense of our country and our people.

Now, having said that, the Administration opposed the new increase at that time. Now the Administration is coming back saying more, more, more, and I am likely to support more, more, more, because some of the same problems that existed when we had our appropriation bill last year still exist. Many of them do. So we will have to spend more for homeland defense.

But this anticipated increase for the military side, I understand it may be $48 or $49 billion over last year. That would be a 15 percent increase over last year. In other words, 2003, if we add $49 billion, which we hear the President may propose in his State of the Union address, or at least in his budget when he sends it up here, that would represent a 15 percent increase over 2002. 2002 represented a 15 percent increase over 2001, and so here in 2 years, we are talking about increases of 10 percent and then 15 percent.

This is something that I only raise here to indicate that we had better take a look, a close look, at what we are doing in defense spending. I hear a lot of talk about spending. I assume that those who are concerned about spending are also talking about defense spending. I am one of the hawks who have been around here 50 years this year when it comes to defense. But I am becoming a little nervous as I hear that we are going to spend more and more and more on the military.

It is going to have to come out of somewhere, out of somebody else's hide. We have just established that we should stay with the pay-as-you-go theory. So I am not getting to a question, but I am just expressing some sense of caution.

Finally, I hope that we Senators and all who have listened and those who have not had the privilege of listening to what you said today will go back and read again what you said. And I hope that those who talk about a stimulus package will particularly pay attention to what you have said today in your testimony concerning short-term stimulus, long-term stimulus, et cetera, et cetera. I think it is very worthwhile—not only very worthwhile reading but good advice.

Finally, may I utter a word of caution? Do you, as someone for whom I have tremendous respect—you used the word "fast-track" when you responded to a question here. I hope that you will not use the term "fast-track." It is all right to use the term "expedited," expedited rules or expedited handling of whatever legislation we are talking about. But I hope that you will not use the term "fast-track" in the sense that I think you used it, and that is with respect to trade legislation.

Let me just read you one provision from the United States Constitution, and it comes from the first paragraph of Section 7 of Article I of the United States Constitution. Here it is: "All bills for raising revenue shall originate in the House of Representatives; but the Senate may propose or concur with amendments as on other bills."

Now, there is the power, there is the origination, if I may use it, in the Constitution, the power of the Senate to amend, not only revenue bills but as on other bills.

Now, when you are talking about fast-track—and we will get into this in another place, at another time, and it will be quite a long speech that I will be prepared to make on this thing. When we talk about fast-track, we are talking about denying the United States Senate its right, its authority, its power to amend trade bills, "as on other bills."

I know there are those who would say, well, the Congress has a right to delegate. We are not delegating here. That is not delegating. Fast-track is taking away from the Senate a basic constitutional right and power, namely, the power and right and prerogative to amend.

So if you would accept my suggestion in the spirit in which it is offered, please don't use the term "fast-track" in answering a legitimate question like that when it is being asked here concerning a trigger.

That is all I have to say, except I would like to ask, if I might, how do you see the trade deficit in this whole equation? Last year, the trade deficit just in the month of November was $27.9 billion, and for the first 11 months of 2001, the trade deficit was $349 billion, and in the year 2000, it was $375 billion. So it looks as though we are well on our way in 2001 to eclipsing the trade deficit of $375 billion in 2000.

Would you have any comment?

Mr. GREENSPAN. Well, Senator, first let me say I heard your words, and the word "fast-track" will not re-emerge from my lips. [Laughter.]

Senator BYRD. Thank you.

Mr. GREENSPAN. I have been worried about the trade deficit for many years. It is a problem which should be creating more difficulty with respect to our international financial position, but it hasn't. And the reason it hasn't is that the investment capabilities within United States companies have attracted a sufficiently large amount of capital, investment capital from, abroad to maintain the financing year after year after year.

I assume at some point it has to come to a halt, but I have been saying that for a number of years, and I am impressed with the attractiveness of American investment opportunities. It seems endless.

Senator BYRD. Thank you. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. Let me say to my Senator on my side, I have not asked yet and I have to leave to get ready to go to New Mexico. So I will go as quickly as I can.

First, Dr. Greenspan, within the last 2 or 3 years, as you testified before this committee and other committees of the United States Congress, you referred to the United States economy in very positive tones and positive words describing the phenomenon of about 10 years of sustained growth without inflation, with sustained productivity increases during that period of time, and you and many chose to call it "a new economy." And——

Mr. GREENSPAN. I don't think I ever used that term, but others have.

Senator DOMENICI. What did you use to describe the kind of economy we had?

Mr. GREENSPAN. An economy going through a major technological change, which occurs periodically. I wouldn't call it "new" because it has happened in the past.

Senator DOMENICI. All right. So for that description and for those who call it a new economy, where are we now? Some things have been washed out and some things remain there, which would indicate that we have a very powerful American economy. How do you describe it now in terms of its potential for future things that are positive and good for America?

Mr. GREENSPAN. Well, Senator, as I commented in my prepared remarks, by all of the evidence that we have, the exploitation of the major technological opportunities were only partially completed at the point when risk premiums rose and the cost of capital rose and we had a significant retrenchment.

But even recent surveys suggest that plant managers indicate that of the technology available to them, only about half has been put in place, and so there is still a very considerable amount of opportunities, real rates of return out there, and in that regard I think that productivity gains will continue certainly in excess of what they did in the quarter century prior to 1995. And, indeed, the remarkable sustaining of growth in output per hour during the last year or two, during the period of significant retrenchment in economic growth, is suggestive of the fact that underlying this very significant weakness in economic activity there is still a strong underlying productivity growth.

Senator DOMENICI. So as we begin to put together a budget, hopefully it could be done by working together on both sides, and maybe with the President, and have something harmonious, as we did immediately following the terrorist activity. I believe that was a short period of time, Dr. Greenspan, when the American people were most proud of us. I am not sure that the results will be as good as we had led everybody to believe when we were doing it. But at least we did it expeditiously, we did it together, and we did it with the President. I would hope we could do that again, but I have great doubts as to whether we can.

But, in any event, Dr. Greenspan, is it your opinion that, based upon the current strength of the American economy, we should be able to put together a budget that is positive and that moves us in the right direction, all things considered, with reference to our economy?

Mr. GREENSPAN. I would certainly think so, Senator.

Senator DOMENICI. Could I, just as my last question, an observation for you? Do you think that the current situation with reference to taxation in America—there are some who say we ought to cut taxes more, there are some who say we cut taxes too much. I have looked at the tax rate imposed on the American people over the past 60 or 70 years, and I conclude that taxation has much to do with America's strength in the economy, that clearly we are still at a higher level of taxation in toto on the American people and institutions of productivity in America. We are at a higher level than we have been on average during the last 50 or 60 years. I kind of think one of the reasons we are superior in productivity and economic activity is because we start with the premise of not wanting to be a high-tax country with all the ramifications that come with that choice.

Do you concur that, using an average, taxes are not low in the United States but year over year they are high?

Mr. GREENSPAN. I would not describe them as low, but I would be a little careful about how one measures tax rates. You cannot use tax receipts over nominal GDP as a tax rate, and largely because a goodly part of the numerator are taxes not on the incomes that appear in the gross domestic product but are capital gains-type taxes.

But having said that, clearly we have had a gradual upward move into upper brackets, which creates so-called bracket creep, which has had an effect of raising rates.

Ultimately, the level of taxation should be what the population in a democratic society chooses, and ultimately, that is indeed what happens. And I agree with you in the sense that most of the surveys that I have seen suggest that the American people think that tax burdens are higher than they would like them to be.

Senator DOMENICI. Well, my last observation, then, and question of you is this: We are engaged in a war, albeit a different kind of war. It costs a lot of money, and it is a war that you cannot decide today that you know exactly the status of the war in 1 year because it is a moving type of target with moving commitments and moving requirements.

I seem to think of the American economy and our current situation of productivity and all those things that make it positive here in America, that we can afford this kind of war, albeit the surpluses are diminishing somewhat for various reasons. Would you concur that we can do that without harming the American economy?

Mr. GREENSPAN. I would certainly hope so because the American economy is quite strong. I mean the resiliency which it has shown through this particular period, I find a very important indication of the underlying strength of our system. Clearly, the military has got the highest priority. National security is a necessary condition for the volubility of our economy. That is, we have seen what happened to parts of our economy as a consequence of September 11th. And it is important to have, as I said at the very early part of this hearing, an economy based on trust and voluntary exchange amongst the participants and to do so in tranquil circumstances. You cannot have a functioning market economy where there is great concern about violence, and to the extent that national security is required to support that, whether it is homeland or what we call defense budgets, clearly, that has got the highest priority.

Senator DOMENICI. Mr. Chairman, I want to close by thanking you for the work you do for our country. As Senator Byrd did, I want to indicate to you that I have the highest regard and personal esteem for you.

Mr. GREENSPAN. Thank you very much, Senator.

Senator DOMENICI. For the short term here you obviously did whatever could be done to thwart the recession. You did what you could on short-term interest rates which had a very positive effect, coupled with the tax cuts. I believe that all had a positive effect. Things would be a lot better, different, negative in the American economy, but for that action, and the action of tax reductions as I see it. Thank you very much.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator and wish him a safe trip.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, and I would echo what Senator Domenici has just said, Mr. Chairman, that I believe that your actions and the actions of the Federal Reserve have had a profound impact as we look at ability for consumers to purchase this year.

I was pleased to notice in your comments, as you talked about consumer spending, receiving a considerable lift from the sales of new motor vehicles. As a member representing Michigan, we certainly invite people to continue to do that. We just came from a North American auto show that was outstanding. And I am hopeful that, as you have indicated, that as we are seeing slowing in the rate of inventories' liquidation, and if we can, as you have indicated, the slowing in the rate of inventory liquidation will induce a rise in industrial production if demand for those products is stable or falling only moderately. So to me, as I listened to your testimony today, which I greatly appreciate having had the opportunity to do again, I hear over and over again issues related to demand, consumer confidence. If people are wanting to buy automobiles, then we will make them, and there is a direct relationship there.

I also appreciate your comment as it relates to pent-up demand in the business sector in terms of technology and equipment and other things, and that says to me in the short run bonus depreciation would certainly have impact; in the short run, understanding that there is a tradeoff for the long run, but I appreciate your comments related to that.

And also, I very much appreciate your comments once again regarding a trigger, and hope that we can call upon you as Senator Snowe and I, and Senator Bayh and others, work through exactly how to do that, and my assumption is that we start from the basis of looking at the goal of a balanced budget and fiscal responsibility, and the extent to which we tie it to debt reduction versus balanced budget. I mean our trigger focused on both spending and tax cut phase-in last year, in order to be able to deal with both. I assume that you would suggest that as well, and I do not know if you have any further comments as it relates to the trigger, but certainly we want to be able to call upon you as we structure this because the concept certainly, I believe, makes sense, and we should have done it last year. But as we write the details—as you know, the devil is in the details—as to how that is structured in a way that allows us to keep the focus on fiscal responsibility.

One other comment and then a question, Mr. Chairman, and that is, I really agree with your statements that it is a very positive thing that there was an outrage about Enron, that that is a positive value, the integrity in the system and the expectation that we have, that we can count on people's integrity and reputations and so on, and that that is a very good thing, and that in fact the actions, and I would argue, deceit of a few powerful people at Enron, are having a disastrous effect on people who work there and investors, on their lives and life savings, and that this is something we should all be outraged about.

My fear is that while it is separate, that if we continue to move as we are in terms of not addressing the long-term impact on the baby boomers in 8 to 10 years, and that if we continue on this track of phasing in tax relief geared to the top 1 or 2 percent of the public, without addressing how that is paid for and in fact depleting Social Security, Medicare reserves known to do that, that in fact, in reality we are going to Enron American families, and I have great concern about the outrage down the road of this kind of situation.

And I would ask—you mentioned a few moments ago that a private insurance company would have a different approach in terms of accruing—I assume you are referring to how they would handle reserves, liabilities and so on very differently, even though we in fact have the public's responsibility for Medicare and Social Security, and I agree with you, we are going to make those benefit payments, the question is how do we pay for that down the road? Is it massive debt? Is it massive tax increase? Is it massive cuts in defense or education or other parts of the economy? But could you speak for a moment, if we were coming at this from a private insurance company, of how that might look differently, when we look at our liabilities?

Mr. GREENSPAN. Senator, a private insurance company can create a life insurance or a retirement annuity system rather simply. It essentially makes a mathematical determination of what is the distribution of the population with which it has to deal, what is its age distribution, what type of benefits would be required, then it works backward in time to find out what type of fund has to be built up at a specific rate of interest, which, at the point at which those payments have to be made, will find that the cash is available. And that is what the insurance industry is all about, it sets premiums in such a manner to accumulate the cash, which, with the rate of interest, will produce a level of retirement benefits that one is seeking.

That is not the way we fund Social Security. We do it in a roughly similar way, but it is extraordinarily rough, and indeed, as I mentioned before, we are very significantly underfunded. In other words, we do not have the assets which will produce revenues of a type required for benefits.

Now, having said that, I am not advocating that we set up a system in which private assets are accumulated in the Social Security Trust Fund. It is an issue which I think requires a very considerable amount of evaluation, but what is clear is for us to recognize that we are not fully funded, that unless we seriously believe we are going to cut back, that we had better try to replicate as best we can private insurance procedures.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

Chairman Greenspan, my apologies for not being here for all of your testimony. Some of us were at the hearing of the Help Committee, where the First Lady, Laura Bush, testified, and as compelling as the testimony of the Chairman of the Federal Reserve is, the First Lady trumps all, and there were several of us who looked around and decided that we needed to be there as well. I do appreciate the chance to catch up on your testimony. I hope I do not go over things you have already covered.

In the past when you have come before this Committee, you have noted the difficulty of getting tax cuts enacted or spending cuts implemented fast enough to provide an economic stimulus. In your speech to the Bay Area Council Conference earlier this month, you said, "Despite the failure of Congress to enact further tax cuts and spending increases, the continued phase-in of earlier reductions in taxes and the significant expansion of discretionary spending already enacted, should provide noticeable short-term stimulus to demand."

In other words, you said we got lucky. But what we did, by enacting tax cuts, was a stimulus package, and through either superior prior planning or dumb luck—and I have been around here long enough to have a suspicion as to which it was—we provided a stimulus. Now, there are those who are talking about repealing the tax cuts. Is this not just about fumbling the good luck we have had and trying to undo the counter-cyclical stimulus that we have provided?

Mr. GREENSPAN. Well, I think the Senator from West Virginia indicated that he did not think it was a feasible or plausible scenario, and for reasons which I am sure you are aware, so I think the question may be moot.

Senator BOND. Well, I had a follow-on question, so I assume that you would—there is a keynesian theory that you should either increase spending or perhaps reduce taxes as a counter-cyclical measure.

Mr. GREENSPAN. Let me just say this, that budgetary problems that are going to exist are going to become increasingly more difficult to deal with, because as we get closer to the next decade, we have to make sure we phase in in an appropriate manner.

I do not know what particular programs that Congress will decide to expand on, rescind or the like, but I would say that it is important that there be a general view of where it is you want to be in, say, 2015, and even though it is an awfully difficult forecast, you are making that forecast implicitly all the time, whether you do it consciously or otherwise. It is far better to try to plan what type of fiscal resources you want out in that particular period rather than leave it, as you put it, to luck.

Senator BOND. Well, let me ask you on the short term. I agree with you on the long term, but there has been talk about a trigger mechanism, and some have actually proposed it, which would either be a triggered elimination of a tax reduction, in other words a tax increase, or a triggered elimination of a spending increase. And my question is: is this not Hooverism? Is this not the problem we got into in the Depression, where we were in a serious depression? We focused on balancing the budget. We have increased taxes, cut spending, which is a compounding rather than a countercyclical fiscal push. Is the trigger not in danger of being a bucket of water on a drowning swimmer, in other words, if you jack up the taxes or cut the spending? Is that not bad policy?

Mr. GREENSPAN. But that is the reason, Senator, why I said it has to be or should be an explicit judgment of the Congress, not something that happens automatically on the basis of some predetermined external event.

Senator BOND. And I would ask you another thing. If you are triggering on statistics, we have had all had the feeling for the last—at least the last 10 months that we are in a recession before the statistics finally confirmed it. We were probably at the bottom. And so I have another concern about triggering any kind of action. Because the statistics come in so late, you are likely to be past the action which you are supposed to be remedying.

Mr. GREENSPAN. That is always a possibility, Senator, but the alternative is to assume that you cannot do something of a positive nature, and in my judgment, if you are doing long-term planning, a goodly part of it is going to turn out to be wrong, but it is far better to try to do it than to do nothing at all because you are making a forecast, you are acting on a forecast, whether you consciously make that judgment or not, and I would suspect that a properly constructed trigger is a definite net benefit and something which could be quite helpful.

Senator BOND. On that I disagree, but thank you, Mr. Chairman.

Chairman CONRAD. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman, and it is great to see you, Mr. Chairman, and I compliment you on your efforts to move our economy forward. I think it is remarkable, the 11 cuts. I wish I could ask you about shapes, the yields curves, long-term rates, the impact on the economy, some more about triggers and maybe the efficacy of various parts of the program.

But I would like to dwell on an issue that has been touched on a number of times with regard to Enron. And I think the real issue is worrying about its impact on human lives, and there are a lot of people that have lost a lot in this process. But I think Senator Murray brought up a point that I think is real and is of a concern. And while I appreciate much of what you commented on with regard to outlook on the economy, are you not worried that Enron has the capacity—the issue, not the company itself, but the issue—of concern about the efficacy of our accounting statements, the efficacy of how people make judgments about investment, about whether the concerns and the issues that have been revealed here are not more broadly applicable in the economy, lead to a rise in the cost of capital, lead to serious concerns about foreigners wanting to continue to invest in America and the way that they have supported us with regard to our foreign trade balance? It just strikes me that this runs the risk of truly undermining business and consumer confidence in a way that is not given the centerpiece—a lot of talk about the details of what we ought to do about it. I certainly would love to hear your initial impressions on it. But what are the macroeconomic effects, and are you concerned about those issues within the context of the kinds of things that I mentioned?

Mr. GREENSPAN. Well, Senator, your colleague, Senator Hagel, raised a similar issue early on, and expressed much the same concern that you are. I actually do not have that concern. Indeed, I think that, as I said before, the extraordinary response to Enron is something very helpful, and indeed an indication that the people in this society have required that we maintain a very high standard of trustworthiness in our business operations. And the response has been of a type which suggests to me that like a number of other societies, we do not tolerate a level of activity in—I do know how you would designate what that activity is, and I probably should not be saying it until we really know what the facts are. But clearly, if, to generalize it, everybody did what is alleged in the Enron accounting system, our system could not work. That is, if you have a system, market system, as you know better than anybody, it works off information. If you do not have a way to evaluate a particular asset, you cannot price it, and if you cannot price it, you cannot get the appropriate allocation of capital in a market economy, and you will not get a high standard of living.

Senator CORZINE. The issue of reputation does not really deal with the efficacy of accounting statements, where restatements of earnings occur on a very frequent basis.

Mr. GREENSPAN. I think that was an egregious act. I tried as hard as I could to find an economic reason why those affiliates were constructed the way they were. The simplest explanation was the obvious explanation, that they did not want to indicate what their true earnings position was.

Senator CORZINE. You have no great concerns that that is a broad based——

Mr. GREENSPAN. You know something? I would if there was not a reaction to it. But the reaction I think is going to create a really major rethinking in a lot of people about whether there is a spin game going on with respect to information coming out of a business into the investment community, and there has been an element of that. But I think everyone has been sort of aware of it and adjusted to it. I think we are going to find there is going to be a good deal less of that, and that the old issue of competing for reputation is going to re-emerge, and I think you are going to find at some point that there are going to be people out there who are going to say that our accounts you can rely on, and that probably will increase their price earnings ratios.

Senator CORZINE. Thank you.

Chairman CONRAD. Senator Sarbanes.

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

Chairman Greenspan, it is a new year and a new session of the Congress, and here you are back before the Congress again. I want to welcome you, and I know you will be before us many times over the next few months.

I just want to take a moment to look back, because on Sunday, Glenn Kessler, writing in the Washington Post says—and I am now quoting him—"Five days after George W. Bush took office, Federal Reserve Chairman Alan Greenspan appeared before Congress and endorsed a large tax cut after years of preaching the virtues of debt reduction. As I noted"—this is Kessler talking—"As I noted in a Washington Post article at the time, Greenspan's new stance dramatically strengthened President Bush's negotiating position. You could almost hear the ice cracking across the Capitol." End of quote.

And I remember that hearing and that testimony, and in fact, my comment on it; I remember saying to you that you had just taken the lid off the punch bowl, and who knew what excesses would follow?

Well, the excesses followed to the point that we went from CBO projecting a budget surplus a year ago of $5.6 trillion, and now they say it is 1.6 trillion over the same period. And the changes in the total budget surplus—this is in an analysis developed by our very able Chairman—show that 42 percent of this loss in the surplus, by far the single most important factor, came from these excessive tax cuts, the ones that are already there.

Now, less than 10 percent of that tax cut took effect in the first couple of years. There are those who argue we really provided stimulus to our economy. To the extent that is the case, that is less than 10 percent of the total tax cut. The rest of it, of course, is projected out into future years, and there is now an effort on the part of some to accelerate that forward. Others want to do yet another tax cut.

So let me first ask you whether you think the ice ought to keep cracking and the lid ought to stay off the punch bowl; do you favor doing additional tax cuts, given the projections we now have with respect to the Federal budget surplus?

Mr. GREENSPAN. Are you referring to the new initiatives on the tax side?

Senator SARBANES. That is right.

Mr. GREENSPAN. That is up to the Congress, and I think that, just going back to your earlier statement quoting me last year, there is no question that my basic desire is for maintaining as low a level of the national debt as we can, because I think it has very great economic advantages. However, I, as you know, an also very strongly opposed to the accumulation of private assets by the Federal Government. If you believe the current policy projections of CBO, or even part of them, at that particular point those two goals, in my judgment, clashed, and——

Senator SARBANES. That was a year ago.

Mr. GREENSPAN. That was a year ago.

Senator SARBANES. They do not clash today, do they?

Mr. GREENSPAN. Well, to go back, I redid the calculations of what would have happened to the current policy budget as of January 2001 if you had the economic data that we have today. And what that would have done would be to move the point at which we would get to irreducible levels of Federal debt about 2 years.

Senator SARBANES. There is a different policy budget now. They do not clash on the basis of the different policy budget, do they?

Mr. GREENSPAN. You mean at the moment?

Senator SARBANES. Yes.

Mr. GREENSPAN. Well, no, because basically the policy is changed.

Senator SARBANES. That is right.

Mr. GREENSPAN. And——

Senator SARBANES. Now, I take it that you would come back to your traditional position of preaching the virtues of debt reduction ahead of either a large tax cut or large spending increases; is that correct?

Mr. GREENSPAN. That is what I have done today, Senator.

Senator SARBANES. All right. I wanted to be clear on that. The reason I am trying to be clear on it is I am really struck by this interpretation of your San Francisco speech. And I know Senator Wyden asked you about it, but I am going to pursue that for just a moment.

John Berry, in the Post, just a few days ago, talking about that speech, said, "Part of the confusion over the speech was due to the subtlety of Greenspan's intended message. Greenspan chooses his words very carefully, keenly aware that his public utterances are closely parsed by the markets and often move global stock and bond prices. An economist who speaks in highly technical language about extremely arcane subjects, he also is so aware of his reputation for impenetrable prose." And of course that is a continuing problem; that is why I said it was a miracle when Senator Byrd said he was asking very straightforward questions and getting very straightforward answers. In fact, in some of the press leading up to this, one article is headed, "What is Greenspan Trying to Say? Market Swoons on Debate. Tomorrow's Senate Testimony Could Clear up the Confusion." And I want to try to clear up the confusion.

Berry says in this article, "Greenspan's intended message"—because some have said, well, it was over interpreted—"intended message was that the recession was likely to end soon, but that a quick, sound rebound was not assured."

And later, in trying to interpret it, he says, "However, in last week's speech, Greenspan cautioned that it was too early to be sure about the nature of the recovery"—and he quotes from your speech—"despite a number of encouraging signs of stabilization. It is still premature to conclude that the forces restraining economic activity here and abroad have abated enough to allow a steady recovery to take hold."

Now, is that an accurate portrayal of your position?

Mr. GREENSPAN. I tried to, in my prepared remarks today, address the issue in the manner in which if there was any confusion, I tried to, as best I could, eliminate it. The difference between—what I was endeavoring to do back there in San Francisco was to indicate that something really quite important has happened in the past year or maybe the last several years. The flexibility and resilience of this economy has clearly improved immeasurably. And the reason we know that is that it has responded with such great flexibility to what has been a very severe set of pressures. I interpret that as a rather positive view of the world at large. And what I was endeavoring to do was to put it in context so we did not assume that everything forward is going to become a type of economic expansion which has occurred out of previous recessionary periods.

Senator SARBANES. Do you think it is premature to conclude that the forces restraining economic activity here and abroad have abated enough to allow a steady recovery to take hold?

Mr. GREENSPAN. No. I do not think we are going to know that for several months.

Senator SARBANES. So you think it is premature?

Mr. GREENSPAN. Well, we are just at this particular point, turning, as best I can judge. In other words, we are close to zero GDP change.

Senator SARBANES. Well, those are not my words that I asked you. Those are your words.

Mr. GREENSPAN. I know, but what I am trying to say is that anyone who thinks they can state with great conviction at this particular point has not been in the forecasting business as long as I have.

Senator SARBANES. Mr. Chairman, could I just put two very quick questions?

Chairman CONRAD. Yes.

Senator SARBANES. In responding to Senator Allard, you indicated you were in favor of spending caps on discretionary spending. Is that correct?

Mr. GREENSPAN. That is correct, Senator.

Senator SARBANES. Is that an implied criticism of the President's indication that he is going to ask for a 14 percent increase in the defense budget?

Mr. GREENSPAN. The discretionary spending procedures basically are caps that the Congress puts on. I am just saying as the general procedure, that it is a very good idea to have caps. What caps do is to limit the spending off the Congress' and the Administration's priorities. I happen to think that defense expenditures are very high priority at this particular stage. And you do what you have to do, but that does not mean you should not try to cap other types of discretionary spending in order to keep the budget under reasonable control.

Senator SARBANES. Would you cap defense spending as well?

Mr. GREENSPAN. I would not say that because defense spending basically——

Senator SARBANES. Well, we did it before.

Mr. GREENSPAN. Well, what I am trying to say is that——

Senator SARBANES. The period that you reflect on, when we brought the budget into balance, I am sorry Senator Domenici left because he played a role in doing that—shifting over from a deficit equal to nearly 5 percent of GDP in fiscal 1992—this is your statement—to a surplus equal to 2–1/2 percent of GDP in fiscal 2000 was truly remarkable. And of course many of us here in this room shared in that achievement, as of course did President Clinton, I might note. Those years actually paralleled his presidency.

Mr. GREENSPAN. The way that was done was by reducing the force structure and changing the underlying structure of our military posture. A great deal of spending that occurs in the Defense Department is longer term, especially in the procurement area, and even in maintenance and operations you do have long-term contracts involved, so that you can move defense spending down only with a significant lead, and you did have a significant lead, and the force structure was run down in a manner which enabled you to get to touch——

Senator SARBANES. Let me get this clear. Are you in favor of excluding defense expenditures from spending caps if we have spending caps?

Mr. GREENSPAN. I might, yes. I think that they require a different type of evaluation than what we usually consider to be spending caps.

Senator SARBANES. And finally, what am I to make of your comment in the first paragraph of your written statement where you say, "I want to emphasize that I speak for myself and not necessarily for the Federal Reserve," as a sort of headline——

Mr. GREENSPAN. The reason I say that is that for a number of the questions that have been posed to me, which I choose to answer, I do not want to imply something that my colleagues necessarily agree with. I think that a large number of them do, but I do think it is important to remember that a number of these issues have not been vetted through the official policies of the Federal Reserve.

When I come before your Committee, on so-called Humphrey Hawkins testimony, that is vetted testimony. At that point I am speaking for the Federal Reserve Board. Today I am not.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Clinton. And let me just say that this will be the last questioner as we have tried to adhere for your time for departure, Mr. Chairman.

Senator CLINTON. Thank you, Mr. Chairman. And I too was with Senator Bond at the hearing where Mrs. Bush appeared, and I apologize that I missed the beginning of your testimony and the questions that were asked.

I agree with your framework of saying that our country needs to set objectives that we expect to be working toward achieving, and that we should do so by asking ourselves where we want to be in 2015, to pick a date. One could pick another date, but that was the one that you referred to, and I think that is a fair way to describe how we should go about determining our budgetary decisionmaking.

And I am following up on Senator Sarbanes' points because when you were here last year, I think many of us, although we were facing some economic indicators that suggested a downturn, believed we had more control over our destiny than perhaps we do right now, that given surpluses and given the rapid rate at which we were paying down debt, that even in the face of an irreducible debt basis of your testimony, which led to the concerns you expressed, we could do the kind of planning that would get us to 2015, having dealt with, in a rational way, the demographic challenges that we faced.

Yesterday when Dr. Crippen testified, and certainly given the uncertainty that you reflect on the future of the recovery and its pace, I think many of us believe we had lost some of that ability for the long term, that we have perhaps even given away the capacity to make the decisions that would put us in a better posture than we see currently available to us.

Now, going back to the San Francisco speech, I just want to make sure that I understood something that I believe you said, because it relates to something we talked to Dr. Crippen about, that the diminished outlook for debt reduction has probably played a role in keeping long-term interest rates relatively high this year. Is that a fair inference from what was said in San Francisco?

Mr. GREENSPAN. That is correct, Senator. I said that there are, in my judgment, two elements involved. One was the expectation of an imminent recovery in economic activity, which would move, other things equal, long-term rates up. But I also stipulated that a deterioration of the long-term fiscal situation was also a contributor.

Senator CLINTON. Well, I happen to believe that, and I think that the high long-term interest rates on a relative basis this year, despite your efforts at the Fed to use monetary policy on short-term rates, has had and will have a continuing negative impact on debt reduction which I think it is at least a fair bet will impede the recovery. I well remember the discussions that you were instrumental in in 1993, when the discussion about how we could craft a debt reduction plan that would lower long-term interest rates, spur economic growth, led to the decisions that were made in 1993.

What I am concerned about now is that just as in 1993, some people criticized the Administration at that time for keying economic policies to bond traders, which I remember very well. It turned out to be a pretty smart bet.

Now, my biggest problem with the tax cut last spring is that I do not think the bond traders were asleep, and whether my colleagues believed the projections of surplus and the impact on the debt as being overstated by those of us who expressed concern, I think the bond traders had a pretty clear and cold eye about what would happen. And as Senator Sarbanes, based on the Chairman's chart, has just reminded us, although in this first year the tax cut impact on the surplus has been minimal. The projected impact is as stated in that chart.

So here we are. I accept those who say politically there will not be any change, there will not be any repeal, there will not be any serious effort to rethink our changed circumstances, but I do not think the market and the cold clear-eyed bond traders are going to be impressed by our failure to exercise responsible fiscal policy in the face of changed circumstances.

So that leads me back to this discussion of a trigger, and I would just clarify, I think, a point that my colleagues, Senator Snowe and Senator Stabenow have repeatedly made, is that their idea for a trigger would not repeal a tax cut, but would delay one until it could be paid for, and the paid-for part of that would take into account the various factors that would be available at the time however it was constructed.

And the final point that I just feel compelled to raise as well, following up on Senator Corzine's comment, is that I agree with your assessment, that the reaction to what has happened with Enron and Arthur Andersen is a healthy reflection of how much we value transparency and accurate information in order to have a functioning market system. But I do not think we are anywhere near the end of this story, and what will really count is what are the consequences. In fact we could further drag down business and consumer confidence, in my opinion, if the outrage is not followed by consequences. And one of my concerns is that at least at present, based on press reports, the discussion about the accounting information practices and how we go forward guaranteeing to people that their outrage is not misplaced raises some serious issues.

And I would, if you believe it within your purview as someone who looks at the entire economy, go at Senator Corzine's question a little differently, which is when the outrage has exhausted itself, will it be important for the continuing functioning of our markets to have an accounting system that is understandable and regulated in such a way that people can put their confidence in the results of whatever the statements might be.

Mr. GREENSPAN. It is hard to know what the next 2 years are going to unfold, or how they are going to unfold, but I think it is reasonably certain that what has come out of this particular event is going to alter the way not only accounting is done in a more transparent way, I think there are effects on corporate governance as well, because the incentive structures in audit committees within corporations, amongst accountants, at least in my judgment, are not optimum for the appropriate allocation of capital within our economy.

Senator CLINTON. Excuse me, Mr. Chairman. Are you suggesting that that will be a self-policing, self-regulating——

Mr. GREENSPAN. I do not know.

Senator CLINTON [continuing]. Formation of human nature that will occur?

Mr. GREENSPAN. No, it is not human nature. Well, in part it is. I mean it is called self-interest. There is a very important economic value in reputation, more so than it has been in recent years, largely because we are increasingly moving toward what I would call a conceptual economy in which physical assets are a decreasing proportion of the market value of firms, and, as I indicated earlier, this reputation, capitalized and placed on the balance sheet, is called goodwill. And it is a major competitive advantage to be able to say to somebody, "Our accounts fully represent what is actually going on in our company." Indeed, those of us who have been involved in bank regulation are aware of the fact that those financial institutions which get into businesses which are somewhat obscure have found that the price-to-earnings ratios of those institutions are less than those who are in businesses which are fully exposed to the light of day in their accounting systems and in the structure of the type of risks they take.

There are going to be changes, and I suspect there may very well be changes in statutes because it is crucially important that the trust which is so fundamental to all transactions in a market economy be reinforced, and I do not know how that is going to happen, but I do know that the pressure to do that as a consequence of this event is going to be significant, and I think that is a very fortunate potential outcome of this rather unfortunate story.

Senator CLINTON. I agree with that. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. And we want to thank Chairman Greenspan for your appearance here today. We have held you somewhat beyond the time that we had agreed to, and I thank you for your patience.

Chairman CONRAD. Let me just say that I especially welcome your suggestion that we revisit the notion of a mechanism to adjust spending and revenue so that we do everything we can to aggressively pay down this national debt in expectation of the baby boom generation's retirement and the desirability of building surpluses in preparation for that time. I think that is a very constructive and important suggestion that you made last year that you have repeated this year, and hopefully we will proceed to try to find a way to get it enacted into law.

I thank you again.

[Whereupon, at 12:51 p.m., the Committee was adjourned.]

THE PREPARED STATEMENT OF SENATOR SENATOR RUSSELL FEINGOLD

Thank you Mr. Chairman, and thank you, Chairman Greenspan. It is always somewhat of an occasion to have you before us. We all recognize just how critical your own thinking and actions are to the economy. For that reason, it is extremely useful for us to hear directly from you.

During the 1990's, you played an important part in our ability to get our fiscal house in order. Many of the individual decisions Congress made in trying to balance the Federal books may have been less than popular, but I think having heard from you about the need for fiscal responsibility made it easier to make the case that a greater good was being served. You convincingly made the case for how fiscal responsibility helped to strengthen our Nation's economy.

Last year, we were presented with budget projections that in many ways did not seem real. We were shown budget surpluses that seemed to grow forever, and we were presented with the likelihood that we would actually be able to pay down the great bulk of our publicly held debt by 2006.

At that time, perhaps because those budget projections seemed so unreal, a number of us on the Committee urged caution. We suggested that it would be a mistake to pursue a policy that relied so completely on those projections.

To its credit, the Congressional Budget Office included cautionary language about those projected budget surpluses. It even provided a chart that graphically demonstrated the range of uncertainty in the projections.

Unfortunately, as yesterday's testimony from Dr. Crippen demonstrated, CBO was right to be cautious. In fact, their projections were literally nearly off the chart. Looking at CBO's chart a year ago outlining the range of possible outcomes, the actual budget experience over the last year is at the extreme limit on the bottom end of that chart—in that portion of the graph that was characterized at the time as the least likely to occur.

As I noted at yesterday's hearing, no one is to blame for inaccurate budget projections. We ask our professional forecasters to do the best job that they can, and they do that job extremely well. In fact, CBO does an excellent job of outlining the assumptions it uses in making these predictions.

But if nothing else, our experience in the past year should teach us that the policy course we choose should reflect the uncertainty inherent in CBO's budget projections. As I said yesterday, we should treat them with a great deal of humility.

That did not happen last year, and as a result, we have an enormous budget hole to fill for years to come.

Chairman Greenspan, for me, one of the more memorable comments made at this hearing last year was made by our colleague, now the Chairman of the Banking Committee, Senator Sarbanes. After listening to your testimony, he expressed his concern that in effect you had given license to those who wanted to stray from the course of fiscal responsibility. The expression he used was that in effect, you had taken the lid off the punch bowl.

In looking back over the last year, I think Senator Sarbanes used an apt analogy.

Congress and the White House have engaged in a binge of spending increases and tax cuts that have left us with a serious budget mess. Some of it, but only a fraction of it, stemmed directly from the events of September 11. Most of it, though, did not.

And apparently, we will be asked to do even more. Reports suggest that the President will be asking for significant increases in spending on Defense, as well as on non-defense. We are also being asked to enact even more tax cuts, in the name of stimulating the economy, many of which are ill-designed to do that job.

With the sobering news about our budget position, one might think that Congress had learned a lesson. But it is the nature of things that people do not like to admit that they have made a mistake, and we may end up with more of the same—spending increases and tax cuts that we cannot afford.

Many who voted for this kind of fiscal policy last year may, in fact, regret that support. Unfortunately, my guess is that they are also reluctant to admit they made a mistake, and would rather ride this policy bomb all the way into the ground, waiving their hats and whooping.

If that happens, if we continue on this course, we will make a bad situation much worse.

Yesterday, Dr. Crippen reminded us all of the challenge we face in the not too distant future. My generation, the baby boom generation, will start to retire, and we will begin to draw upon Social Security, Medicare, and Medicaid. Meeting the commitments those programs make poses an enormous challenge. We need to put the budget back on a path that will enable us to meet those commitments. Digging the budget hole even deeper will not help.

WRITTEN QUESTIONS FROM SENATOR BYRD TO CHAIRMAN GREENSPAN AND THE RESPONSES

Question. Chairman Greenspan, I believe in productive public investments in infrastructure and human capital. Decades of economic growth have overwhelmed many of the Nation's sanitation, public transportation, and energy technology and delivery systems whose original designs back fifty to a hundred years.

Would investments in modernizing and expanding this infrastructure contribute to stronger economic growth?

Answer. There can be little doubt that investment in infrastructure—both public and private—is an important prerequiste for economic growth, and our Nation has benefited over time its high-quality infrastructure. The evident acceleration in the growth potential of our economy in recent years likely has placed strains on some aspects of our infrastructure and correspondingly raised potential rates of return of return to additional investment. However, as a general matter, economists have had a difficult time establishing a clear-cut empirical link between public investment in infrastructure and economic growth. This difficulty almost certainly reflects, in part, the uneven rates of return to the public investments that have been undertaken in the past. As a consequence, there can be little substitute for an evaluation of infrastructure investment projects on a case-by-case basis.

THE BUDGET AND THE ECONOMY

TUESDAY, JANUARY 29, 2002

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, Stabenow, Clinton, Corzine, and Domenici.

Staff present: Mary Ann Naylor, staff director; and Chad Stone, chief economist.

For the minority: G. William Hoagland, staff director; and Bob Stein, chief economist.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The committee will come to order.

Senator Domenici is in an Energy Committee hearing elsewhere and will be joining us a little later.

As you know, this is a very odd week because of the State of the Union today and because of party caucuses starting tomorrow. So it is an unusual week, and I apologize to the witnesses for that, but we think this is a very important hearing to talk about the economic conditions that we face.

Today is really the third in a series of hearings on that question. We started with Dr. Crippen, Director of the Congressional Budget Office, who gave us an overview of our current economic condition and the fiscal condition of the country.

We then followed with Chairman Greenspan of the Federal Reserve, who gave us a more detailed look at our current economic conditions and prospects going forward.

The news so far has been dramatic. As Dr. Crippen testified, just a year ago, we were told that we would have surpluses of $5.6 trillion over the next 10 years. That has now been reduced, as the chart shows, to $1.6 trillion, a disappearance of some $4 trillion of budget surpluses.

That has enormous implications. Instead of effectively eliminating the publicly held debt by 2008, as we were told last year, we now know that we will still have $2.8 trillion of publicly held debt by 2008. And of course, instead of building up some $2.7 trillion of surpluses outside of Social Security and Medicare, the new projection is that we will be running a deficit of $1.1 trillion. And those are of course baseline estimates—that is before any additional defense buildup, which we now know the President will call for in just the next few days; that is before his proposal for dramatic increases in homeland security; for a stimulus package or for prescription drug coverage for seniors, or other things that are not in the so-called baseline forecast.

What caused these changes? CBO is clear that over the next 10 years, the biggest reason for the diminished surplus is the tax cut, which accounts for 42 percent of the decline.

The other factors are economic changes, the economic slowdown, which accounts for some 23 percent of the change; other legislation, largely spending as a result of the attacks, some 18 percent of the change; and then, technical changes which account for some 17 percent. Technical changes are things like a difference in estimations of Medicare and Medicaid expenses. The CBO has increased their estimates of the expenses in those areas.

The question before this committee is what do we do now, what do we do going forward, what should our policy be.

Clearly, the performance of the economy will affect the budget and vice versa. Chairman Greenspan indicated that he believed the worst of the recession is over, and the economy is beginning to stabilize. But even with that, we see the unemployment rate is still rising, with now 8.3 million people unemployed. We will get new data for January this Friday.

At the same time, there are hopeful signs. We see consumer confidence starting to rise. For example, in the chart, we see the major indexes of consumer confidence showing a move up, and people are expecting a new reading from the Conference Board later this morning. When that news comes, we will report it to the committee.

And of course, the Federal Reserve has cut short-term interest rates aggressively. That brings up an important question of why have long-term rates stayed up while the Federal Reserve has so dramatically cut short-term rates.

This chart I think tells a very important story. We see the results of the Federal Reserve Board sharply cutting interest rates but long-term rates showing very little change. And this is true across a broad range of measures of long-term interest rates.

There is another important point that I think needs to be addressed, and that is a point that Chairman Greenspan made in a speech in San Francisco earlier this month, and he repeated the point at our hearing last week—that one of the reasons why long-term interest rates have not come down is the falling surpluses and diminished prospects for paying down debt.

Chairman Greenspan said in his speech in San Francisco, and I quote: "Some of this stimulus has likely been offset by increases in long-term market interest rates, including those on home mortgages. The recent rise in these rates largely reflects the perception of improved prospects for the U.S. economy. But over the past year, some of the firmness of long-term interest rates is probably the consequence of the fall of projected budget surpluses and the implied less rapid paydown of the national debt."

I think this is something that all of us have to be aware of as we fashion a policy going forward. The importance of fiscal discipline for promoting strong and sustainable growth is one of the issues I hope we will explore today.

As Chairman Greenspan has said: "All else being equal, a declining level of Federal debt is desirable because it holds down long-term real interest rates, thereby lowering the cost of capital and elevating private investment."

I believe that Chairman Greenspan has that right. I think that that is the correct analysis for economic policy.

But there is another key reason for fiscal discipline and for attempting to rebuild surpluses, and that is the demographic time bomb that we all know that we face. The baby boom generation will start retiring in just 6 years. That is the leading edge of baby boomers who choose to retire at age 62, and it will begin in just 6 years, and that is going to change everything.

As Director Crippen said last week, "Acting sooner rather than later to address these long-term fiscal imbalances will make an important difference."

Today we have three witnesses from outside Government to give us their perspective on the economic and budget outlook and to help us address these issues.

Robert Reischauer is President of The Urban Institute and before that was Director of the Congressional Budget Office.

Peter Orszag is a Senior Fellow at the Brookings Institution and was Special Assistant to the President for Economic Policy and a Senior Economist and Senior Advisor at the President's Council of Economic Advisers in the Clinton administration.

Brian Wesbury is Chief Economist at Griffin, Kubik, Stephens, and Thompson, a Chicago-based investment bank, and served as Chief Economist at the Joint Economic Committee in 1995 and 1996.

We welcome all of you and thank you very much for coming.

My very able ranking member, Senator Domenici, has arrived, and I will turn to him for any opening statement that he would choose to make, and then we will go to the witnesses.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much, Mr. Chairman. I will not take a lot of time.

I thank the witnesses for giving of their time here today. By coming here, you contribute a lot to our understanding of what we ought to be doing. Each of you has had very successful input and participate mightily in how things turn out and what we should be thinking about.

In particular, Dr. Reischauer, I do not think I should ever let your appearance at the committee go without thanking you for the enormous amount of public service you have put forward. I do not want to start recalling the very important issues that were decided when you were CBO Director, but suffice it to say that you were the epitome of what that office should be, and I thank you for it then and thank you for it today.

I have some prepared remarks, Mr. Chairman, and I will put those in the record.

Frankly, I am convinced that we are going to return to surpluses of a significant amount as soon as the American economy turns around and goes from its current level of growth, which is nothing, to a level of 2.8, 3.5, and it might even during this recovery go up above that for short periods of time, although I do not see this recovery as being a raucous recovery that is going to be filled with bull markets month after month. But I believe that to talk about trying to get the surpluses back where they were without acknowledging that the principal reason we got them to the height they were was that we had a sustained growth economy—we need to get back to that.

I have some indications in my opening remarks with reference to long-term interest rates, where they are going, where they are now, where they were during most of the Clinton time in the White House, and frankly, we are not doing so badly, and from what I can tell, we are doing pretty good.

I do not believe there is anything that we can do in the next year or two that will dramatically alter those long-term interest rates, but I do believe they are going to ameliorate and get better over time, not worse.

With those few words which, instead of me saying them, we ought to be asking you for your opinions, nonetheless I thank you again.

And I want to say to the Chairman that I think I told you and told your staff and did tell the witnesses that I have a hearing in the Energy Committee on Enron, and I happen to be the second in charge on the Republican side, so I guess I had better go there, and if I can find time, I will run back.

So I thank you much, and I will try my best to pass judgment on what you say here today by reading it and reviewing it with one of my trusted staff, so it will be attended to by me as if I were here.

Thank you very much, and thank you, Mr. Chairman.

Chairman CONRAD. Thank you very much, Senator Domenici.

[The prepared statement of Senator Pete V. Domenici follows:]

STATEMENT OF SENATOR DOMENICI

Thank you, Mr. Chairman, and good morning.

Once again, I'd like to thank everyone involved in the move of the committee out of the Russell Building and back into Dirksen. Specifically, I'd like to thank Lynn Seymour, George Woodall, Sahand Sarshar, Mandy Wimmer, and Tim Nolan.

Now, I'd like to welcome all of our witnesses her today—a very accomplisjed group. Dr. Reischaeur, I'd like to welcome you back to Capitol Hill.

I see Dr. Orszag is with us again after testifying three times last year.

Mr. Wesbury also testified once last year and in the meantime won an award from the Wall Street Journal as the most accurate economic forecaster in 2001. Unlike most economists, who didn't forecast a recession until 6 months *after* it started, Mr. Wesbury forecast a recession as far back as January last year. That's impressive, although I think he knows that his is a humbling occupation. My former Chief Economist at the committee won the same top honors twice for her forecasts in 2000 but came in dead last on her predications for 2001.

Today, we are here to examine the relationship between the economy and budget outlook.

Listening to some of my colleagues, one might get the impression that we are moving toward some sort of fiscal collapse and that interest rates are going through the roof.

But as Chairman Greenspan testified last week, “our underlying fiscal situation remains considerable stronger than that of a decade ago.”

The new CBO baseline from last week shows the debt as a share of GDP falling to the lowest level since 1917.

And at only 5.1 percent, long-term interest rates are low—not high. In fact, rates are lower now than they were in 90 of the 96 months of the Clinton administration.

This does not mean we are without any fiscal challenges. Social Security and Medicare require long-term attention. Our ability to make these programs work depends heavily on strong economic growth.

I believe the tax cut we enactd last year will enhance economic growth in both the short-term *and* the long-term, and thereby help address, in part, the future of Social Security and Medicare.

Has our fiscal position changed since last year? Of course it has. We have had a recession and the start of a war. Under these circumstances, a couple years of deficits are, maybe not desirable, but appropriate.

In the near term our fiscal policy must focus on national security, homeland security, and economic security.

It is our responsibility to produce a budget that preserves the security of our citizens on all these fronts. As I have said before, nothing much else can matter at this time.

Having said that, I hope we can work *together*—in a bipartisan manner—to produce a budget plan that focuses on these three security issues; and I look forward to hearing our witnesses this morning.

Chairman CONRAD. We will begin with Dr. Reischauer. Welcome. Please proceed with your testimony.

My intention is to have the entire panel give their testimony, and then we will open it up for questions.

Thank you.

STATEMENT OF ROBERT D. REISCHAUER, PRESIDENT, THE URBAN INSTITUTE

Dr. REISCHAUER. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before the committee. I will summarize my statement, which reviews the latest baseline budget projections, draws a couple of straightforward lessons from the experience of the last year, argues that fiscal discipline remains an important goal for the Congress and that you should work to extend and revise the procedures that have been used in the past to attain this fiscal discipline, and it makes the case for augmenting the fiscal flexibility that is available to lawmakers in the future.

Last week, CBO reported to this committee a sharp deterioration in the budget outlook from the situation that faced the Congress just a year ago. In the short run, meaning the current year and next year, the major explanation for this deterioration is the weakness in the economy. In the long run, meaning 2009 through 2011, the dominant explanation is the tax legislation that was enacted last June, which accounts for roughly half of the deterioration that occurs during those years.

While the baseline outlook certainly is less robust than it was a year ago, the Nation is not facing the budget difficulties that it faced from the early 1980's through the mid-1990's. During those years, the budget projections showed that deficits would grow unless Congress cut spending below or raised taxes above baseline levels.

CBO's new projections how that the unified budget will return to surplus when the economy recovers if Congress adheres to baseline spending and baseline revenue numbers.

However, as you know better than I do, it will be very difficult to keep spending or taxes at baseline levels over the next decade. If one adds to the baseline the amount necessary to complete the unfinished business that is before Congress now—and by that, I mean the farm bill, some disaster assistance, likely 2002 supplemental, and extension of the expiring provisions of the Tax Act—the outlook is nowhere near as rosy.

Adding resources for new priorities such as a Medicare prescription drug benefit, increased medical research at NIH, a true fix for the AMT, and other items that are being debated would make the projections even less optimistic.

Looking at that situation, I concluded in my statement that it will be a challenge simply to attain and then maintain balance in the unified budget over the course of the next decade.

This raises the question of what the fiscal goal for the Nation should be. For many years, there was a consensus that we should try to balance the unified budget. Over the last 4 years, however, a broad bipartisan consensus emerged around the notion that we could do better than that, that we should balance the non-Social Security portion of the budget at least in good times and devote Social Security surpluses to paying down debt or to investing in structural reform of those programs.

Considering the challenges facing the Nation when the baby boomers begin to retire and the Nation's low personal savings rate, I think a fiscal goal like this, one that calls for a significant unified budget surplus in good times, is an appropriate goal; but the rough estimates of the realistic budget outlook facing the Nation that are in my testimony suggest that we are not going to be even close to this mark over the course of the next decade. In fact, we are likely to have on-budget deficits in the $100 to $200 billion range as far as the eye can see.

If Congress wants to reserve some of the Social Security surpluses for debt reduction, it will have to take steps now to increase the fiscal flexibility that is available for the Nation in the future. I suggest in my statement that the most straightforward way of doing this would be to modify the provisions of the 2001 Tax Act.

Specifically, I suggest making permanent and indexing all of the provisions that have been implemented to date and placing the remaining provisions on hold until we have restored a desirable level of fiscal flexibility. While some might characterize this proposal as a tax increase, it is in fact a tax cut for both 2003 and for all of the years after 2010 relative to current law. It would also represent a tax cut in the intervening years for the majority of families who face either the 10 or the 15 percent marginal tax rate.

This proposal, while not raising taxes above levels that people are currently paying, would restore sufficient fiscal flexibility so that Congress could address not only its unfinished business, but also the needs that will emerge over the course of the next decade.

Thank you.

Chairman CONRAD. Thank you very much.

[The prepared statement of Dr. Reischauer follows:]

PREPARED STATEMENT OF ROBERT D. REISCHAUER[1]

Mr. Chairman and members of the committee, I appreciate this opportunity to discuss with you some of the challenges facing the Congress this year as it makes its decisions about the fiscal 2003 budget. This statement:

[1] President of the Urban Institute. The views expressed in this statement should not be attributed to the Urban Institute, its sponsors, staff, or trustees.

- reviews the latest baseline budget projections and suggests that the baseline may be outside the range of politically attainable paths;
- draws some straightforward lessons from the sharp and unexpected deterioration in the budget outlook over the past 12 months;
- argues that fiscal discipline remains important and that Congress should revise and extend the procedures and mechanisms that facilitated budgetary restraint during the 1990's; and
- makes the case for augmenting the fiscal flexibility available to future lawmakers by modifying the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

WHAT A DIFFERENCE A YEAR CAN MAKE!

When the Congressional Budget Office (CBO) released its baseline budget projections a year ago, they showed growing surpluses over the 2002–11 period in both the unified budget and the on-budget accounts, surpluses that cumulated to $5.611 trillion and $3.122 trillion, respectively, over the 10-years (see Chart 1). For many who had struggled through the dark decades of large and seemingly intractable deficits, CBO's January 2001 projections were like passing through the pearly gates to the promised land of fiscal plenty. Resources appeared to be available to address many of the Nations priorities simultaneously—to reduce tax burdens, strengthen defense, modernize Medicare, expand aid to education, reduce the ranks of uninsured, help farmers, boost national saving and so on. Spirited debates even developed over the maximum feasible pace at which debt held by the public could be retired and the investment dilemma Treasury would face when government ran surpluses after all of the public debt had been retired.

Last week, CBO released its latest baseline projections before this committee. In sharp contrast to those of a year ago, they showed unified budget deficits for 2002 and 2003 and deficits in the on-budget accounts through 2009 (see Charts 2 and 3). The cumulative unified budget surplus for the 2002–11 period had shrunk to $1.601 trillion and the on-budget accounts were projected to have a cumulative deficit of $742 billion over the period (see Chart 1).

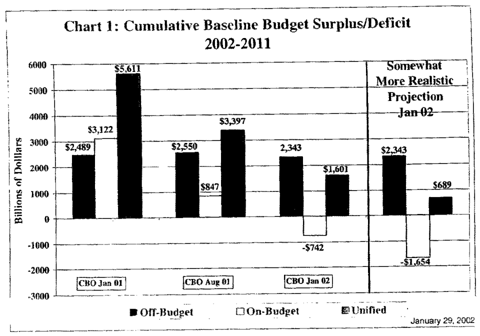


Chart 1: Cumulative Baseline Budget Surplus/Deficit
2002-2011
Somewhat
More Realistic
Projection
Jan 02
Billions of Dollars
$2,489
$3,122
$5,611
$2,550
$847
$3,397
2,343
-$742
$1,601
$2,343
-$1,654
$689
CBO Jan 01
CBO Aug 01
CBO Jan 02
Off-Budget
On-Budget
Unified
January 29, 2002

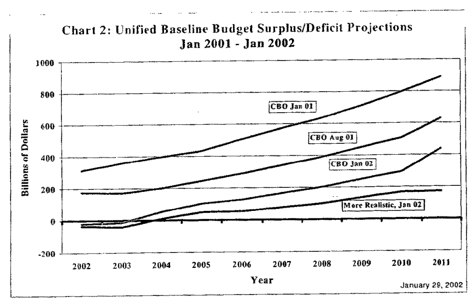
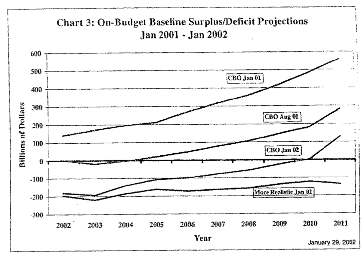
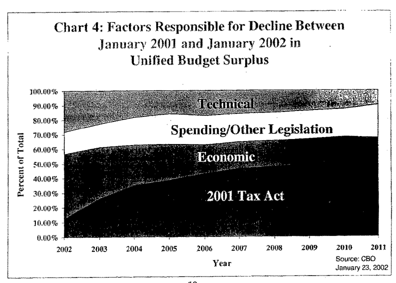


Chart 2: Unified Baseline Budget Surplus/Deficit Projections
Jan 2001 - Jan 2002
Billions of Dollars
CBO Jan 01
CBO Aug 01
CBO Jan 02
More Realistic, Jan 02
Year
January 29, 2002

CBO carefully enumerated the factors behind the sharp deterioration in the baseline outlook. Over the short run—2002 and 2003—the changed economic forecast is the dominant explanation, accounting for 40 percent of the deterioration (see Chart 4). In the later years, the revenue loss attributable to EGTRRA and the associated debt service dominate, accounting for half of the total deterioration in the baseline budget outlook in the 2009–11 subperiod.





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While CBO's more pessimistic projections of January 2002 represent a sharp contrast to those it made a year earlier, they need to be kept in perspective. Notwithstanding the wailing of those who would like to convey a sense of extreme fiscal crisis, the new projections do not foretell a return to the budget dynamic of the 1980's and early 1990's when, unless Congress took steps to curb the growth of spending or raise revenues, already large deficits would grow inexorably. Under the baseline scenario, relatively small deficits, which should cause little concern while the economy remains weak, turn into surpluses as the economy strengthens. This means that, if the economy unfolds along the path expected by most economists, the budget will not get mired in large deficits again unless the 107th Congress and its successors pass legislation that reduces revenues or increases spending above baseline levels.

However, as you know better than I do, it will be very difficult to adhere to the fiscal restraint implicit in the baseline and so the baseline projections may prove to be a somewhat misleading indicator of the attainable, let alone the likely, future budget outlook. Rarely have the policies underlying the baseline projections been as disconnected from the policy makers' agendas as they are today. The rules and conventions that govern the construction of the baseline budget appropriately do not take into account the partially completed business before the Congress, provisions of the tax code that expire but are likely to be extended, or initiatives with bipartisan support that seem highly likely to be enacted soon. A short list of such items before the 107th Congress would include the farm bill, a fiscal 2002 supplemental of defense and homeland security, extension of expiring provisions of the tax code, and adequate resources to cope with natural disasters. The rather sanguine picture that the CBO baseline portrays for the second half of the decade deteriorates moderately if one adds to the CBO baseline reasonable amounts for these priorities. This scenario is portrayed, in a very rough fashion, in Charts 1 through 3 by the bars and lines labeled "more realistic" projection. While the non-Social Security accounts remain in deficit throughout the projection period, small unified budget surpluses still characterize the second half of the 10-year projection period.

Abstracting from the uncertainty surrounding budget projections, even this picture is probably too optimistic. It does not encompass an economic stimulus package, the possibility that Congress might increase payments to Medicare providers above baseline levels as MedPAC has recommended, a Medicare prescription drug benefit, or added resources for defense, NIH, Amtrak, those without health insurance, and other perceived priorities. Of course, above-baseline spending in these areas could be financed by restraining spending in other programs below baseline levels and by closing so-called tax loopholes. However, such tradeoffs are likely to be difficult in the current political environment where majorities are narrow and bipartisan consensus on policy matters elusive. In short, even without considering the unforeseen needs that inevitably will emerge as the decade unfolds, it will be a challenge just to maintain balance in the unified budget after the economy recovers from the recession.

LESSONS FROM 2001

The experience of the past 12 months provides a textbook example of the uncertainties inherent in budget projections and underscores why such projections should be used with utmost caution when pushing forward legislative agendas.

The budget outlook changed dramatically from that assumed in the January 2001 CBO baseline for three reasons. First, there was a deliberate, major policy change—the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001—in June. This legislation reduced revenues and increased debt service costs by some $1.7 trillion over the 2002–11 period. It also preemptively provided beneficial fiscal stimulus to an economy that was sliding into recession and introduced considerable uncertainty in the future fiscal picture. This uncertainty derived from the acts failure to extend the many provisions of the tax code that expire between 2002 and 2010, its creation of two new provisions (AMT relief and a deduction for education expenses) that terminate at the end of 2004 and 2005, respectively, and its "Cinderella's coach" provision which has the tax code revert, not to a pumpkin, but to its pre-EGTRRA structure at midnight on December 31, 2010.

Second, contrary to the expectations of CBO, OMB and most economists in January 2001, the economy slid into a recession that the NBER has determined started in April 2001. The recession reduced the growth rate of nominal GDP for 2001 by 1.5 percentage points below CBO's expectations and caused a sharp drop in corporate profits. The continued slide in stock market values reduced capital gains realizations and the value of stock options. These developments depressed revenue growth.

In July, when the Bureau of Economic Analysis issued revised national income and product account figures, it lowered its estimates of nominal and real GDP growth, investment, productivity increases and corporate profits for the 1998–2000 period. These revisions have cause some economists, CBO included, to dampen a bit their expectations about the economy's long-run growth potential. Less robust growth in the short and long run has reduced projected levels of nominal GDP and future budget surpluses.

Finally, the terrorist attacks of September 11 caused a sharp shift in the Nation's priorities. The needs associated with an active military engagement abroad, the destruction and loss of life in New York, the Pentagon, and Pennsylvania, and increased homeland security and anti-bioterrorism measures became paramount. The President and Congress responded by appropriating for fiscal 2001 and 2002 tens of billions of dollars above baseline levels to meet these new priorities. And these amounts were viewed as only a down payment on a longer-term commitment.

One clear lesson that can be drawn from the experience of 2001 is that there is no way to predict with certainty today the nature or magnitude of tomorrow's priorities. This suggests that, in long-run budget planning, Congress should leave a considerable margin of fiscal flexibility for future lawmakers. A second lesson is that the strength of the economy, which has such a crucial impact on the budget, is not only impossible to predict with any certainty over the long run but also can be difficult to forecast accurately even in the short run. This second bitter pill suggests that Congress should exercise caution in its budgetary decisions, especially when the economy seems to be approaching a peak or trough in the business cycle.

ESTABLISHING A FRAMEWORK FOR THE BUDGET DEBATE

Not only has the budget outlook changed dramatically over the past year, but the consensus framework in which budget issues were debated has dissipated and some of the procedures that restrained profligate behavior during the 1990's have expired. These developments will make it more difficult to maintain fiscal discipline in the future. Nevertheless, for several reasons, fiscal restraint should remain an important, if not paramount, goal of policymakers. First, healthy growth and economic stability are more likely if the Federal Government is not running large and persistent budget deficits. Second, the Nation will be better able to cope with the unavoidable challenges posed by the aging of the population if fiscal discipline is maintained and the government is not saddled with large and growing debt service obligations when the baby hoomers begin to retire. Third, policy choices tend to be more rational and debate less contentious when fiscal discipline prevails. In an environment of persistent deficits, policies designed to address the Nation's problems often are constrained or distorted and, therefore, less effective. Symbolic rather than substantive responses to problems are too often adopted. Finally, policymakers are less likely to resort to procedural gimmickry—such as Constitutional amendments requiring a balanced budget and lock box prescriptions—if fiscal discipline is maintained.

The first step policymakers need to take to reestablish a framework for the budget debate is to agree on an appropriate fiscal goal for the Nation. From the end of World War II through the early 1960's, the consensus fiscal goal of policymakers was to balance the administrative budget, a target attained in 6 of the 16 years from 1947 through 1962. From the mid-1960's through the late 1970's, the goal was refined to be balancing the unified budget over the business cycle. In other words, deficits would be tolerated when the economy was operating significantly below its capacity but surpluses would be expected when the economy's resources were fully utilized. Only once during this period was the target achieved. As deficits persisted and grew, the goal became balancing the unified budget no matter what the state of the economy, a goal that was finally achieved, quite unexpectedly, in fiscal 1998.

When rapid economic growth, a soaring stock market and political gridlock combined to generate surpluses in the government's non-Social Security accounts in fiscal 1999, policymakers began to consider raising the bar. By January of 2001, a broad bipartisan consensus had developed around the notion that, at a minimum, the Nation's fiscal goal should be to balance or maintain small surpluses in the non-Social Security accounts while devoting Social Security's surpluses to debt retirement or structural program reform. Some wanted to go farther and wall off the Medicare Hospital Insurance surpluses for debt reduction or Medicare reform. Lock box proposals, which the sponsors claimed would realize these goals, proliferated.

After September 11 discussions about the appropriate fiscal goal for the Nation ceased. Nevertheless, the Budget Committees should, as part of their consideration of the fiscal 2003 budget resolution, attempt to develop a consensus around a long-run fiscal goal for the Nation. It could be to balance the unified budget, achieve balance in the non-Social Security accounts, or meet some other target. Of course, no single goal is analytically right or economically optimal. The choice of a target depends on judgments—how one values present versus future needs, how one values public versus private goods, and what one thinks is politically sustainable. What may be the appropriate goal for the current decade may be quite different from that which makes the most sense for the next 10 years. While the CBO projections suggest that Congress will find it challenging just to sustain balance in the unified budget, I would urge you to set your sights higher and strive to maintain unified budget surpluses of 1 percent to 1.5 percent of GDP during good economic times. Maintaining balance in the non-Social Security budget would be a slightly more ambitious goal, but one with more political appeal.

Once a fiscal goal is agreed to, procedures must be established to achieve and sustain fiscal discipline. During the 1990's, this was accomplished through enactment every few years of multi-year deficit reduction packages whose terms were enforced by discretionary spending caps and pay-as-you-go (PAYGO) restraints on mandatory spending and revenue measures. The system worked fairly well from fiscal 1991 through fiscal 1998 because the spending caps were achievable in the post-cold war environment, fear of deficits loomed large, the economy was strong, and political gridlock prevailed. After 1998, the effectiveness of this approach deteriorated. The spending caps established by the 1997 Balanced Budget Act, which called for real reductions in discretionary spending of roughly 10 percent between 1998 and 2002, were politically unsustainable in an era of growing surpluses. The payment reductions imposed on Medicare providers were too deep for many to absorb at a time when their costs were beginning to rise rapidly and payments from other sources were constrained. And so Congress flouted the restraints of the Budget Enforcement Act. Nevertheless, gridlock on major initiatives and a strong economy kept the surpluses growing through fiscal 2000.

Notwithstanding the record of the past 3 years, experience suggests that multi-year discretionary spending caps and PAYGO restraints can serve useful roles if Congress wishes to adopt procedures that lead to the attainment of a specific fiscal goal sometime in the future. Prospectively establishing caps on discretiorary spending several years in advance would almost certainly restrain spending below the levels that would result from a process in which limits were set annually through the budget resolution. To be effective, however, spending caps and PAYGO restraints must be realistic—they must reflect the overall budget situation, the fiscal goal, and changes in the political consensus. Both restraints must be flexible enough to accommodate the vicissitudes of the budget—they must be able to bend, but not too much.

Should the budget outlook improve markedly to the point where the fiscal goal was likely to be exceeded—the situation Congress faced in early 2001—some more sophisticated process than that of the Budget Enforcement Act would be more appropriate. Elsewhere I have suggested that, under such circumstances, it would be prudent to limit each Congress' ability to encumber future surpluses that were projected to exceed the fiscal goal. For example, if the goal were to maintain balance in the non-Social Security portion of the budget and CBO's baseline projections showed large and growing on-budget surpluses, the budget resolution would be required to place limits on spending and revenue legislation so that new initiatives absorbed no more than 80 percent of the surpluses projected for the next 2 years, 70 percent of the surpluses projected for the following 2 years—on down to 40 percent of the surpluses projected for years nine and ten. Such a calibrated system recognizes that the uncertainty that surrounds budget projections increases the farther in the future one projects. It also reflects the reality that today's lawmakers may not be the best judges of the Nation's needs 5 or 10 years hence. If future legislators are left with some significant fiscal flexibility, they will be able to address the Nation's problems without raising taxes, reducing spending on necessary programs, or increasing the deficit.

DEVELOPING FISCAL FLEXIBILITY FOR THE FUTURE

Realistic estimates of the budget outlook, such as those discussed earlier in this statement, suggest that it will be a challenge to attain and then maintain balance in the unified budget if lawmakers complete the unfinished business before the 107th Congress. In other words, little if any of Social Security's surpluses will be available to pay down debt or invest in structural entitlement reforms over the next 10 years. And nothing will be available for emerging priorities. In short, taxes will have to be raised, program spending cut, or unified budget deficits tolerated to address future problems.

Congress could avoid placing future policymakers in this painful predicament by adopting measures now that create greater fiscal flexibility in the future. The most straightforward approach would be to modify the provisions of the EGTRRA. From its enactment, this legislation was incomplete and required further action. The provisions that provide AMT relief and deductions for educational expenses terminate in mid-stream, and the entire act sunsets after 2010. With the deterioration in the long-run budget outlook and the emergence of new priorities, the uncertainty surrounding the level of tax relief that the Nation will consider prudent after 2010 has increased.

To eliminate this uncertainty, consolidate the tax cuts that have already been implemented, and create greater fiscal flexibility for the future, it would be judicious to index and make permanent all of the currently effective provisions of EGTRRA and put the provisions that are not yet implemented on hold. As Congress debates the disposition of any future surpluses that exceed the agreed-upon fiscal goal, it would be free to activate the various frozen provisions. But they would have to compete with other national priorities for the available resources.

Very rough estimates suggest that this proposal would provide well over $300 billion in increased fiscal flexibility over the 2003–12 period relative to the CBO baseline. Compared to a scenario in which the AMT relief and education expense deductions are extended and EGTRRA is made permanent after 2010, the savings could well exceed $600 billion. A very rough idea of how this proposal would change the non-Social Security budget outlook is provided in Chart 5. Rather than facing continued budget deficits as depicted in the “more realistic” baseline scenario, on budget surplus would reemerge after 2010. These surpluses could be used for further tax cuts or other national priorities.

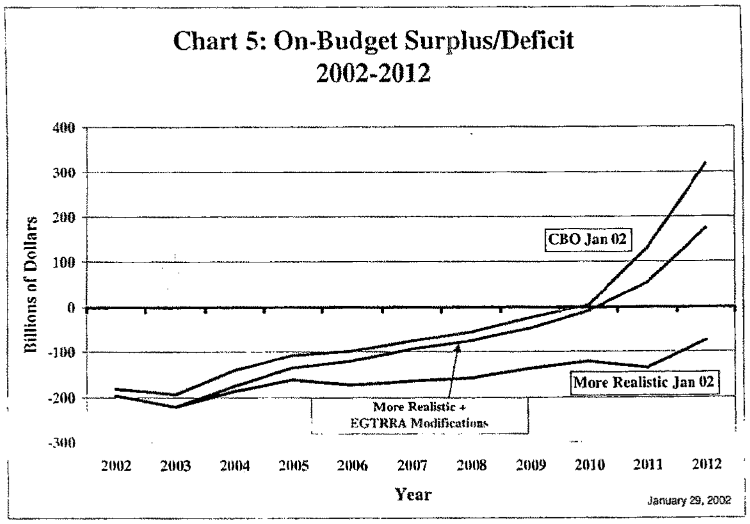
Chart 5: On-Budget Surplus/Deficit
2002-2012
400
300
200
100
0
-100
-200
-300
Billions of Dollars
CBO Jan 02
More Realistic Jan 02
More Realistic +
EGTRRA Modifications
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
Year
January 29, 2002

Some will characterize this proposal as a tax "increase." In fact, for both 2003 and for the period after 2010, it represents a reduction in tax burdens imposed by current law, in addition, throughout the whole period, indexing the bottom bracket would provide tax relief, relative to current law, to the majority of taxpayers who face the bottom two marginal rates.

CONCLUSION

The budget outlook is not as rosy as it was 12 months ago. Notwithstanding the deterioration that we have already seen, the Nation is in a far stronger fiscal position than it was anytime from the late 1970's through the mid-1990's. If the Nation slips back into serious budget difficulties, it will be because of decisions yet to be made. With so many outstanding promises, however, it will be difficult to make the tough decisions needed to keep out of such difficulties. To strengthen its resolve and structure its actions, the Congress needs to lay out a clear fiscal goal for the Nation and revise the budget process so that it can help attain that objective.

Chairman CONRAD. Dr. Orszag, again, welcome. It is good to have you here. Please proceed with your testimony.

STATEMENT OF PETER R. ORSZAG, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Dr. ORSZAG. Thank you, Mr. Chairman.

It is an honor to appear before you and the committee to discuss the interactions between the budget and the economy.

The focus of my testimony is the economic and budgetary effects of the tax cuts that were passed last year but that have not yet taken effect.

Assuming that all the sunsets in the legislation are removed, the long-term cost of the tax bill is a little over 1.5 percent of GDP. About half of that reflects the provisions that are already in place, and about half reflect the tax cuts that are yet to come, primarily in 2004 and 2006 and some estate tax changes thereafter.

These future schedule tax cuts have some benefits, but their economic costs in my opinion outweigh their benefits in both the short run and the long run.

First, the short run effects. The scheduled future tax cuts adversely affect the economy in the short run because financial markets are forward-looking, and the fiscal deterioration caused by the future tax cuts raises long-term interest rates today.

It is perhaps instructive to review what has happened to interest rates during 2001. As you noted in your opening remarks, Mr. Chairman, over the past year, as the Federal Reserve has moved aggressively to bolster a weakening economy, short-term rates have declined sharply. Normally, when short-term rates decline, long-term rates tend to do so as well. Over the past year, however, long-term rates have remained fairly flat. Indeed, the interest rate on 10-year bonds has actually increased slightly.

This failure of long-term rates to decline with short-term rates has an adverse effect on the economy today. It represents a lost opportunity to reduce mortgage costs and spur investment spending, which would bolster the economy in the short run.

A critical question is why long-term rates have failed to decline. To be sure, many factors influence interest rates, and it is difficult if not impossible to parse out precisely the specific impact of the various factors at play. Nevertheless, Federal Reserve Chairman Alan Greenspan, former Treasury Secretary Robert Rubin and others have concluded that the tax cut enacted last year appears to have played an important role in keeping long-term rates higher than they would otherwise be.

Furthermore, every major macroeconomic model, such as the one used by the Federal Reserve, suggests that the tax cut would raise long-term rates relative to what they would be in the absence of the tax cut.

In case you have any lingering doubts about the connection between long-term interest rates and fiscal policy, I would refer you to four other sources—the Reagan administration, the first Bush administration, the current Undersecretary of the Treasury, and Professor Marty Feldstein of Harvard, a leading conservative economist—all of whom are quoted in my written testimony to the effect that fiscal policy has important effects on long-term interest rates.

For example, in the words of the first Bush administration, and I quote: "Economic theory and empirical evidence indicate that expectations of deficit reduction in future years, if the deficit reduction commitment is credible, can lower interest rates as financial market participants observe that the government will be lowering its future demand in the credit market. Lower long-term interest rates will reduce the cost of capital, stimulating investment and economic growth relative to what would be predicted if expectations were ignored."

That same logic, again from the first Bush administration, would suggest that reducing future surpluses would raise long-term rates today and potentially be contractionary in the short run.

The bottom line is that unless every major macroeconomic model, as well as the analyses of the other prominent economists I just mentioned, are wrong, the conclusion must be that the tax cut has played at least some role in the failure of the long-term rates to decline over the past year.

Indeed, my conclusion from the major macroeconomic models is that the tax cut as a whole may be keeping long-term rates between 50 and 100 basis points—that is between half a percentage point and a full percentage point—higher than they would otherwise be, and the components not yet implemented may be keeping long-term rates between 25 and 50 basis points higher.

To give you some sense of the impact of these magnitudes, note that a decline of 100 basis points in mortgage rates would reduce the annual payment on a $150,000 mortgage by more than $1,000. So the lost opportunity there is a mortgage reduction of more than $1,000 per year for a family with a $150,000 mortgage.

Administration officials not only deny the adverse immediate consequences of future tax cuts through this interest rate effect. They also argue affirmatively that future tax cuts can spur economic activity in the short run, even before the tax cuts take effect. The argument that future tax cuts have significant positive effects on economic activity today is belied by several studies of previous policy changes that were also announced before they were implemented. These studies strongly suggest that people tend not to spend tax cuts prospectively. Instead, they largely wait until the money is in their pockets.

For example, one recent paper examined the Reagan tax cuts. Those tax cuts took effect in phases, with one set occurring in October 1981, another in July 1982, and a third in July 1983. The paper found that households did not increase their spending until the tax cuts actually were in effect. In other words, in order to get households to spend, you cannot just show them the money, you actually have to give it to them.

In summary, the overall net effect on the economy from tax cuts scheduled for the future is likely to be negative in the short run. The adverse effect from higher long-term interest rates is considerably larger than any small positive impact that may result from increased spending now in response to future tax cuts.

These short-run economic costs of the future scheduled tax cuts may be worth bearing if in the long run, the tax cuts brought large and significant positive economic benefits. Unfortunately, however, the available evidence suggests that the long run benefits are also likely to be minimal, and their overall long run effect may even be negative.

For example, the Congressional Budget Office has concluded that with respect to the tax cut as a whole, "The cumulative effects of the new tax law on the economy are uncertain but will probably be small."

The reason that the impact is small is that the positive effect from reducing marginal tax rates, getting people to work more and perhaps take more risks, is offset by reduced national saving, so you have a positive incentive effect but an adverse effect from reductions in national saving, and the two factors offset each other, which is why CBO concluded that whether the tax cut will raise or lower real GDP in the long run is unknown, but any effect is likely to be less than half of a percentage point in 2011.

Finally, it may be worth noting that whatever the effect of the tax cuts scheduled for the future on the economy in the long run, they have significant budgetary costs. Indeed, the cost of the tax cuts still scheduled for the future, assuming that the sunsets are removed, are larger over the next 75 years than the entire deficit in Social Security. That may help you to put the magnitudes in perspective. Again, the tax cuts that are not yet in place but that are scheduled under the previous tax legislation, assuming that we remove the sunsets, cost more over the next 75 years than the entire deficit in Social Security.

In conclusion, the tax cuts scheduled for the future are likely restraining the economic recovery in the short run, by keeping long-term rates higher than they would otherwise be, and they would do little to boost economic output in the long run because any positive incentive effects would be offset by reduced national saving. They would also add significantly to the long-term budget challenge facing the Nation.

In light of this, let me briefly share with you a possible compromise that my colleague William Gale and I have advocated.

Basically, there are two things that both sides should agree on. First, whatever one thought about the affordability of the tax cuts last year, it has to be the case that they are less affordable now, given that we know that we will need homeland security and defense spending. Second, the tax cuts that have already been implemented will be extremely difficult to reverse even when they officially sunset in 2010 or before.

In light of these lonely points of agreement, our compromise is simply this: Make the tax cuts that are already in place permanent, but postpone the other ones until the projected 10-year budget surplus outside of Social Security and Medicare grows to be at least as large relative to the economy as it was immediately following passage of the tax cut, when the Congress thought it was preserving that much room in the rest of the budget even after the tax cuts had been passed.

Since about half of the long-term costs of the tax cuts are already in effect, the result gives each side of the tax debate half of what it wants—half of the tax cut would be made permanent, and the other half would be frozen until it was clearly affordable. Freezing the tax cuts until they are affordable, while also making the existing tax cuts permanent, would thus offer a little to both sides, and it would help to end the budget charade, which involves artificial cost estimates based on the official sunsets that has unfortunately confused the debate over the Nation's political and economic choices.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Dr. Orszag.

[The prepared statement of Dr. Orszag follows:]

PREPARED STATEMENT OF DR. PETER R. ORSZAG[1]

Mr. Chairman and members of the committee, it is an honor to appear before you to discuss the interactions between the budget and the economy. The focus of my testimony is the economic and budgetary effects of the tax cuts that were passed as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), but that have not yet been implemented.

An appendix table to this testimony presents the major provisions in EGTRRA by the year in which they take effect. Assuming that all the sunsets in the legislation are removed, the long-term cost of the tax bill as a whole is roughly 1.6 percent of GDP.[2] About half of that long-term cost reflects provisions that are already in effect, and the other half reflects provisions that take effect after 2002.

The tax cuts that have already taken effect have supported aggregate demand in the economy at a time when such stimulus was beneficial. For example, the rebates sent out in August and September provided timely stimulus to the economy by helping to boost consumer spending in a weak economy. The early evidence, however, suggests the beneficial impact was likely to have been quite modest. The evidence suggests that most households saved, rather than spent, the rebates.[3]

The focus of my testimony, however, is the tax cuts that are scheduled for future years, not the ones already in place. Although the future scheduled tax cuts have some benefits, their economic costs outweigh their economic benefits in both the short run and the long run.

• To summarize my results:

The tax cuts scheduled for the future raise long-term interest rates and therefore impede economic activity today. The important linkage between future fiscal policy and long-term interest rates is recognized in all major macroeconomic models (such

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[1] The views expressed in this testimony are those of the author and should not be attributed to the staff, officers or trustees of the Brookings Institution. I thank Robert Cumby, William Gale, Robert Greenstein, Richard Kogan, and Gene Sperling for helpful discussions, and David Gunter and Jennifer Derstine for excellent research assistance. For further discussion of many of these issues, see Peter Orszag and Robert Greenstein, "Future Tax Cuts and the Economy in the Short Run," Center on Budget and Policy Priorities, January 28, 2002.

[2] This figure reflects the present value of the tax cut relative to the present value of GDP over the next 75 years, using the same discount rate as applied by the Social Security actuaries under their intermediate cost estimates for that period and assuming that all sunsets in EGTRRA are removed.

[3] See Matthew Shapiro and Joel Slemrod, "Consumer kesponse to Tax Rebates," NBER Working Paper 8672, December 2001. It should be noted that the tax cuts already in effect have contributed to higher long-term interest rates (as have the tax cuts not yet in effect), so the net impact on the economy in the short run from the already implemented cuts is unclear and may not be positive.

as that of the Federal Reserve), as well as in analyses by such noted policymakers and economists as Chairman Greenspan, former Secretary Rubin, the Council of Economic Advisers under the Reagan administration and the (first) Bush administration, Professor Martin Feldstein of Harvard, and Professor John Taylor (the current Undersecretary of the Treasury for International Affairs).

- Any short-run benefit from the scheduled future tax cuts—which could arise if the tax cuts induced households to spend today based on the expectation of lower taxes in the future—is likely to be minimal. Evidence, including from the phase-in of the 1981 Reagan tax cuts, strongly suggests that households do not respond to tax cuts until they take effect. In any case, any potential positive effect in the short run from future tax cuts is likely to be dominated by the negative effect from higher interest rates.
- The long-run benefits of the tax cuts scheduled for the future are similarly minimal because any positive incentive effects from lower tax rates in the long run are offset by the adverse effects from lower national saving. The overall effect of the yet-to-be-implemented tax cuts on economic activity in the long run may, if anything, be negative. The Nation faces severe budgetary pressures as the baby boomers begin to retire. The tax cuts scheduled for the future make these budgetary pressures more severe. For example, the tax cuts not yet implemented cost about 0.8 percent of GDP in present value over the next 75 years, which is slightly larger than the projected deficit in Social Security over the same period. In addition, the future tax cuts disproportionately benefit high-income households, raising the issue of whether proceeding with the scheduled reductions will benefit high-income families (who will disproportionately enjoy the tax reductions) at the expense of low- and moderate-income families (who may disproportionately bear the burden of any spending reductions necessitated by the future tax cuts and the desire to avoid excessive debt levels).
- In light of the long-term budgetary pressures facing the Nation, as well as the confusion created by the sunsets in EGTRRA, a possible compromise would freeze the tax cuts that have not yet taken effect while also removing the sunset on the tax cuts already in effect. More precisely, the compromise would freeze the tax cuts that have not yet been implemented until the projected 10-year surplus outside Social Security is as large as it was immediately following passage of the tax cut. But to clarify budget accounting and eliminate any ambiguity about whether the tax cuts already in effect will be continued, the compromise would also remove the sunsets on the tax cuts that have already been implemented.

SHORT-RUN ECONOMIC EFFECTS OF SCHEDULED FUTURE TAX CUTS

The scheduled future tax cuts adversely affect the economy in the short run because financial markets are forward-looking, and the fiscal deterioration caused by the future tax cuts therefore raises long-term interest rates today. The increase in long-term interest rates, in turn, increases the cost of business investment and home mortgages—and restrains economic activity.

There are two ways to see how the scheduled tax cuts affect shorter-term interest rates in the future, and therefore affect longer-term interest rates immediately:

- First, one effect of the future tax cuts is that the government will be saving less than it otherwise would (i.e., it will be running smaller surpluses). As a consequence, the pool of saving available for investment will be reduced. Firms competing for this smaller pool of investment funds will push up the price of borrowing funds—that is, raise future interest rates.
- An alternative, but fundamentally equivalent, way of grasping the relationship between the tax cut and interest rates recognizes that the amount of debt the government is projected to pay down in the future will be smaller (and the national debt will consequently be larger) as a result of the tax cut. The amount of Treasury bonds held by the public will therefore be higher in the future than it would be without the tax cut. To persuade investors to hold more bonds, the government will have to offer a higher interest rate.
- The scheduled tax cuts thus exert upward pressure on future interest rates. Since financial markets determine long-term interest rates *today* largely on the basis of what they expect shorter-term interest rates to be in the future, the expected increase in shorter-term interest rates in the future drives up long-term interest rates now. By raising long-term interest rates now, tax cuts scheduled for the future discourage investment and interest-sensitive consumption, thereby impeding economic activity today.

Recent interest rate movements

It is perhaps instructive to review what has happened to interest rates recently. Over the past year, as the Federal Reserve has moved aggressively to bolster a weakening economy, short-term interest rates have declined sharply. Between the beginning of 2001 and the beginning of 2002, for example, the interest rate on 3-month Treasury bills fell from 5.5 percent to 1.7 percent.

Normally, when short-term rates decline, long-term interest rates tend to do so as well. Over the past year, however, long-term rates have remained fairly flat despite the steep decline in short-term rates. The interest rate on 10-year Treasury bonds actually increased slightly during 2001, from 5.0 percent to 5.2 percent. In other words, short-term interest rates have declined substantially but long-term rates have not.

Although the precise relationship may depend on many factors and fluctuates over time, long-term rates have tended to move by about half as much as short-term rates, on average, over the past two decades.[4] Based on this historical relationship, the 3.8 percentage point decline in short-term rates during 2001 should have corresponded to a decline in long-term rates of a bit under 2 percentage points. Instead, long-term rates increased slightly. In other words, given the decline in short-term rates and the average historical relationship between changes in long-term rates and short-term rates, one would have expected long-term rates to be almost 2 percentage points lower than they are today. [5]

An alternative perspective is obtained by examining what happened during the 1990–1991 recession relative to what has happened thus far during the current recession. The current recession began in March 2001. In the 9-months since March, short-term interest rates have fallen by 280 basis points (2.8 percentage points) and long-term rates have risen slightly. In the 9-months following the beginning of the 1990–1991 recession, by contrast, short-term interest rates fell by 200 basis points (2 percentage points) and long-term rates fell by more than 40 basis points (0.4 percentage points). Based on this relationship from the 1990–1991 recession, we would have expected long-term rates to fall by about 60 basis points since March 2001. Instead, they rose by about 20 basis points—so that 80 basis points is "missing."

The upshot is that given the declines in short-term rates, one would have expected long-term rates to be somewhere between 80 basis points (based on the relationship between short rate and long rates from the 1990–1991 recession) and 200 basis points (based on the historical average relationship over the past two decades) lower than their current levels. To be sure, long-term rates remain relatively low today, which has helped to shore up the housing market, but they would have been expected to be lower given historical relationships and the decline in short-term rates.

This failure of long-term rates to decline with short-term interest rates has an adverse effect on the economy. For example, a decline of 100 basis points in mortgage rates would reduce the annual payment on a $150,000 mortgage by more than $1,000. The substantial decline in long-term rates that would have been expected, given the decline in short-term rates, would also boost investment spending, thereby spurring the economy. A critical question is *why* long-term rates have failed to decline.

The tax cut and long-term interest rates

Many factors influence interest rates, including fiscal policy, economic growth projections, investment expectations, savings trends, international capital flows, and expected inflation. It is difficult, if not impossible, to parse out precisely the specific impact of the various factors that affect interest rates. Nevertheless, Federal Reserve Chairman Alan Greenspan, former Treasury Secretary Robert Rubin, and others have concluded that the tax cut enacted last year appears to have played an important role in keeping long-term rates higher than they would otherwise be.

For example, in a speech delivered on January 11, 2002, Chairman Greenspan noted that "over the past year, some of the firmness of long-term interest rates prob-

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[4] A regression of the annual change in the 10-year constant maturity yield on the annual change in the 3-month constant maturity yield from 1982 to 2001 yields a coefficient on the change in the 3-month yield of 0.52 (using the Prais-Winston transformed regression estimator to address serial correlation in the errors). The coefficient is slightly lower if the time period is restricted to the late 1980's to the present, but is roughly 0.5 if the time period is restricted to the 1990's.

[5] It should be noted that long-term rates did decline during 2000, and part of that decline in long-term rates could have reflected an anticipated decline in short-term rates during 2001. But short-term rates appear to have fallen by more than had been anticipated in late 2000. This story therefore does not explain the failure of long-term rates to decline in response to the unanticipated decline of short-term interest rates during 2001.

ably is the consequence of the fall of projected budget surpluses and the implied less-rapid paydowns of Treasury debt."[6] In earlier Congressional testimony, Greenspan indicated there was "no question" that the tax cut enacted last year affected long-term interest rates.[7]

Secretary Rubin has similarly noted, "If you look at interest rates over the course of the last year, market interest rates, they, basically, have not come down, 5-year and 10-year government rates. Fixed rate mortgages rates did not come down last year. They came down vs. 2 years ago, but they did not come down over the course of last year. And I believe one factor responsible for that was the enormous deterioration in our fiscal position over time. . .[8]

Furthermore, every major macroeconomic model—such as the one used by the Federal Reserve—suggests that the tax cut would raise long-term rates relative to what they would be in the absence of the tax cut. [9] For example, previously published results from the macroeconomic model used by the Federal Reserve Board, adjusted to reflect the size of the tax cut passed last year, would suggest that the tax cut would raise 10-year interest rates by between 56 basis points and 80 basis points after 1 year (i.e., by between 0.5 and 0.8 percentage point), and by between 77 and 112 basis points after 10 years.[10] I should emphasize that these figures reflect an interpretation of previously published estimates from the Federal Reserve, roughly adjusted to fit the cost of EGTRRA; they do not reflect an official estimate from the Federal Reserve of the effects of the tax cut.

In 1995, the Congressional Budget Office evaluated the impact of a fiscal shift that was somewhat larger (amounting to a cumulative reduction in the 10-year budget balance of roughly 2.6 percent of GDP) than the EGTRRA produced.[11] CBO concluded that the interest rate movement from such a fiscal policy change would not credibly amount to as much as 400 basis points (which was the estimate from the DRI macroeconomic model), but that "those who expect [budget shifts] to have little or no impact on interest rates probably overstate their case as well."[12] CBO concluded that the budget shift it studied would change 10-year interest rates by 170 basis points after 5 years, with more modest interest rate changes in years one through four.[13] The implication is that EGTRRA would raise 10-year rates by about 90 basis points after 5 years.

In 1994, the Council of Economic Advisers used the Solow growth model, which is commonly used to study long-term economic performance, to examine the impact of the 1993 deficit reduction package on interest rates. It estimated that raising government saving by 1.75 percent of GDP would reduce interest rates by 200 basis points in the long-term.[14] The implication is that a permanent tax cut of 1.6 percent of GDP (as under EGTRRA) would ultimately raise long-term rates by about 180 basis points.

Despite these results from mainstream macroeconomic models and the considered judgment of experienced market observers like Alan Greenspan and Robert Rubin,

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[6] Alan Greenspan, "The Economy," Remarks at the Bay Area Council Conference, San Francisco, January 11, 2002. It is important to distinguish, as Chairman Greenspan does in his speech, the most recent uptick in long-term interest rates, which are now higher than they were in October 2001, from the fact that long-term rates failed to decline over 2001 as a whole. The more recent increase is likely tied to expectations of faster growth in the future, not the tax cut; the effects of the tax cut were already reflected in long-term rates by October and thus cannot explain the increase in rates since then. But, as Greenspan indicated, the tax cut likely played a significant role in keeping long-term rates as high as they already were in October.

[7] Testimony of Alan Greenspan before Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 24, 2001.

[8] Face the Nation, CBS, January 6, 2002.

[9] See William G. Gale and Samara R. Potter, "An Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," forthcoming, *National Tax Journal*.

[10] David Reifschneider, Robert Tetlow, and John Williams, "Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/US Perspective," *Federal Reserve Bulletin*, January 1999, Table 4. The figures in the text assume the tax cut amounts to between 1.1 and 1.6 percent of GDP. Over the next 10 years, the tax cut costs roughly 1.1 percent of GDP; over the next 75 years, it costs roughly 1.6 percent of GDP (in present value and assuming all sunsets are removed). See Richard Kogan, Robert Greenstein, and Peter Orszag, "Social Security and the Tax Cut: The 75-Year Cost of the Tax Cut is More than Twice as Large as the Long-term Deficit in Social Security," Center on Budget and Policy Priorities, revised December 13, 2001.

[11] See William G. Gale and Samara R. Potter, "An Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," forthcoming, *National Tax Journal*.

[12] Congressional Budget Office, "Analysis of the President's Budgetary Proposals for Fiscal Year 1996," April 1995, page 56.

[13] Congressional Budget Office, "Analysis of the President's Budgetary Proposals for Fiscal Year 1996," April 1995, Table B–2, page 53.

[14] Council of Economic Advisers, *Economic Report of the President*, February 1994, pages 81–87.

some officials have argued that the tax cut has not played any role in keeping long-term rates high. When asked recently to respond to Greenspan's comments on long-term rates, for example, one top White House official responded: "I disagree with the implication here that it was the tax cuts."[15]

To support their argument that the tax cuts do not affect long-term interest rates, these officials contend that the econometric literature does not demonstrate a robust relationship between budget shifts and interest rates. To be sure, the results from the literature are mixed; one review of the literature noted that "it is easy to cite a large number of studies that support any conceivable position."[16] But it is assuredly not the case that the literature conclusively demonstrates that fiscal policy does *not* affect interest rates. The wide array of results found in the literature simply suggests that efforts to quantify any relationship between fiscal policy and interest rates have been flawed. As two leading economists, Douglas Elmendorf of the Federal Reserve and Gregory Mankiw of Harvard, conclude in a summary of the literature: "Our view is that this literature. . .is not very informative."[17]

In case you have any lingering doubts about the connection between long-term interest rates and fiscal policy, I would refer you to four impeccable sources: the Reagan administration, the first Bush administration, the current Undersecretary of the Treasury for International Affairs, and Professor Martin Feldstein of Harvard:

- In 1984, the Reagan administration wrote: "Measures to reduce the budget deficit would lower real interest rates and thus allow the investment sector to share more fully in the recovery that is now taking place primarily in the government and consumer sectors."[18] The same logic would suggest that reducing future surpluses would raise real interest rates and discourage investment.
- In analyzing the 1990 budget agreement, the Bush administration—that is, the first Bush administration—wrote: "The new budget law, for example, reduces the budget deficit from what otherwise would be expected. Economic theory and empirical evidence indicate that expectations of deficit reduction in future years, if the deficit reduction commitment is credible, can lower interest rates as financial market participants observe that the government will be lowering its future demand in the credit market. That can mitigate a potential short-run contractionary effect. In other words, expectations of lower interest rates in the future will lower long-term interest rates today. Lower long-term interest rates will reduce the cost of capital, stimulating investment and economic growth relative to what would be predicted if expectations were ignored."[19]
- John Taylor, the current Undersecretary of the Treasury for International Affairs, constructed a sophisticated, forward-looking, multi-country model that contained strong linkages between fiscal policy shifts and long-term interest rates. He estimated that a fiscal policy tightening that amounted to 3 percent of GDP would reduce long-term interest rates by more than 150 basis points in the long run.[20]
- Professor Martin Feldstein of Harvard has attempted to overcome one of the shortcomings of the econometric literature by including a measure of projected deficits in his analysis. (One reason that the literature is not particularly informative is that, as noted above, expectations of future fiscal surpluses or deficits have important effects on interest rates, but many econometric analyses ignore them.) A paper by Feldstein finds a large effect on interest rates; he concludes that "each percentage point increase in the 5-year projected ratio of budget deficits to GNP raises the long-term government bond rate by approximately 1.2 percentage points. . .[21]
- The bottom line is that unless the major macroeconomic models—as well as the analyses of Chairman Greenspan, Secretary Rubin, the Reagan administration, the (first) Bush administration, Professor Taylor, and Professor Feldstein—are wrong, the conclusion must be that the tax cut has played some role in the failure of long-term rates to decline over the past year. indeed, my conclusion from the

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[15] Novak, Hunt, and Shields, CNN, January 12, 2002.

[16] B. Douglas Bernheim "A Neoclassical Perspective in Budget Deficits," *Journal of Economic Perspectives*, Spring 1989.

[17] Douglas Elmendorf and Gregory Manldw, "Chapter 25: Government Debt," in Handbook of Macroeconomics (1998), page 1658.

[18] Council of Economic Advisers, *Economic Report of the President*, February 1984, page 62.

[19] Council of Economic Advisers, *Economic Report of the President*, February 1991, page 64.

[20] John Taylor, *Macroeconomic Policy in a World Economy* (WW Norton: New York, 1993), pages 270–273. It should be noted that Taylor explicitly modeled a reduction in government purchases, not a change in taxes.

[21] Martin Feldstein, "Budget Deficits, Tax Rules, and Real Interest Rates," Working Paper No. 1970, National Bureau of Economic Research, July 1986, page 48.

major macroeconomic models is that the tax cut as a whole may be keeping long-term rates between 50 and 100 basis points higher than they would otherwise be, and may ultimately raise long-term rates by between 75 and 200 basis points.

The same reasoning suggests that the scheduled future tax cuts alone are keeping long-term rates higher than they would otherwise be. Indeed, since the scheduled future cuts represent about half of the long-term cost of the tax package as a whole, the estimates above would suggest that the scheduled future cuts themselves are keeping long-term rates between 25 and 50 basis points higher than they would be in the absence of the scheduled future reductions, and may ultimately raise long rates by between 35 and 100 basis points.

The failure of long-term rates to decline impedes economic activity today. It raises the costs of home mortgages, and discourages both interest-sensitive consumption and business investment.

Positive short-run effects from future scheduled tax reductions

Administration officials not only deny the adverse immediate consequences of future tax cuts through this interest rate effect. They also argue affirmatively that future tax cuts spur economic activity in the short run. For example, Bush economic adviser Lawrence Lindsey argues in a recent op-ed article that expected future tax reductions have a positive effect on the economy in the short run.[22]

Some supporters of the future tax cuts are internally inconsistent on this issue. They simultaneously argue that the future tax cuts will not raise interest rates, by invoking a theory under which households offset expected budget shortfalls in future years by saving more today, and that the future tax cuts will spur spending today. But if households must raise their saving to fully offset the impact of the tax cut on the budget in future years, they could not also increase their spending today in response to the tax cut. These two arguments contradict each other.[23]

More importantly, the argument that future tax cuts have significant effects on economic activity today is belied by several studies of previous policy changes that were announced before they were implemented. These studies strongly suggest that people tend *not* to spend tax cuts prospectively; instead, they largely wait until the money is in their pockets.[24]

For example, one recent paper examined the Reagan tax cuts; those tax cuts took effect in phases, with one set of tax reductions occurring in October 1981, another set occurring in July 1982, and a third set of cuts taking effect in July 1983. The paper found that households generally did not increase their spending until the tax cuts actually were in effect.[25] Another paper, by economist James Poterba of MIT, studied the 1975 tax rebate, which was announced before it was paid. This research, too, concluded that "consumers do not adjust consumption in anticipation of tax changes."[26] Still other research by David Wilcox of the Federal Reserve Board suggests that households do not respond to announced changes in Social Security benefits until the cash is actually in their hands.[27] The evidence strongly suggests that households do not respond much to tax cuts or other policy changes until the cash is in their hands. These findings suggest that any short-run stimulus to spending from tax cuts that will not take effect until future years is quite limited. And to my knowledge, the idea that future tax cuts will raise saving now receives no support from the literature whatsoever.

In summary, the overall net effect on the economy from tax cuts scheduled for the future is likely to be negative in the short run. The adverse impact from higher long-term interest rates is considerably larger than any small, positive impact that may result from increased spending now in response to future tax cuts.

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[22] Lawrence B. Lindsey, "Why We Must Keep the Tax Cut," *Washington Post*, January 18, 2002, Page A25.

[23] It is also worth noting that a reduction in future tax rates could induce individuals to substitute work effort from the current period into the future period. Many supporters of EGTRRA believe that individuals are highly responsive to tax rates, which would make this concern loom larger than if individuals were (as my interpretation of the empirical evidence suggests) largely unresponsive to marginal tax rate changes.

[24] One factor suggesting a somewhat stronger short-run effect from the future tax cuts is that those tax cuts disproportionately accrue to higher-income families, who are less likely to be liquidity constrained than lower-income families. On the other hand, higher-income families may also have a lower marginal propensity to consume out of permanent income, mitigating the short-run impact.

[25] Nicholas Souleles, "Consumer Response to the Reagan Tax Cuts," forthcoming, *Journal of Public Economics*.

[26] James Poterba, "Are Consumers Forward Looking? Evidence from Fiscal Experiments?" *AEA Papers and Proceedings* (1988), pages 413–418.

[27] David Wilcox, "Social Security Benefits, Consumption Expenditure, and the Life Cycle Hypothesis," *Journal of Political Economy* (1989), pages 288–304.

LONG-RUN ECONOMIC EFFECTS OF SCHEDULED FUTURE TAX CUTS

The analysis above has focused on the short-run effects from the future scheduled tax cuts. This section briefly analyzes the longer-run effects. It first examines the longer-run economic effects from the future scheduled tax cuts, and then turns to the longer-run budgetary effects.

Economic effects in the long run

The short-run economic costs of the future scheduled tax cuts may be worth bearing, even though the economy is currently in a recession, if the impact of those cuts on economic activity in the long run were positive and substantial. Unfortunately, however, the available evidence suggests that the long-run economic benefits from the future scheduled tax cuts are likely to be minimal, and the overall long-run effect may even be negative.

Some proponents of the tax cut package—including the tax cuts scheduled for the future under EGTRRA—argue that it will significantly raise economic output in the long run by cutting marginal tax rates. For example, a Heritage Foundation report argued, "Because of steep personal income tax rates, highly productive entrepreneurs and investors can take home only about 60 cents of every dollar they earn, not including State and local taxes or other Federal taxes. This reduces the incentive to be productive. Lower tax rates will reduce this 'tax wedge' and encourage additional work, savings, investment, risk-taking, and entrepreneurship."[28]

The basic logic of this argument is that reducing marginal tax rates can increase the incentives to work, to take risks, and to save, all of which can encourage additional economic activity.[29] The crucial question, however, is the size of *these* effects. The most recent academic evidence suggests that marginal tax rate reductions would have only modest effects on future economic activity in the long run.[30]

Tax cuts, furthermore, have an important downside from an economic standpoint: they reduce national saving. Tax cuts result in lower national saving because funds used for the tax cuts would primarily result in increased consumption, while funds used to pay down debt primarily increase savings. The fundamental benefit of higher national saving is that it will expand income in the future. Higher national saving leads to higher investment, which means that future workers have more capital with which to work and are more productive as a result.[31] The increased productivity generates a larger economy, a higher national income, and a higher standard of living in the future.[32]

In evaluating the impact of the future tax cuts on long-run economic performance, one must include both any potential positive effects from reducing marginal tax rates *and* the negative effects from reducing national saving.

Studies that have examined EGTRRA as a whole have generally found minimal long-term benefits.[33] For example, an early paper that I wrote (before the tax legislation was passed) concluded that the benefits of the lower tax rates from EGTRRA would raise economic output in 2012 by 0.5 percentage points, but that the reduction in national saving caused by the tax cut could reduce real GDP in 2012 by between 0.6 and 0.9 percentage points.[34] The overall effect was thus a small reduction in GDP in 2012, because the benefits of the marginal tax rate changes were too

[28] Daniel Mitchell, "Reducing Tax Rates Across the Board: A Cornerstone of Pro-Growth Tax Relief," Heritage Foundation Report No. 711, January 16, 2001.

[29] It is worth noting that even theoretically, the impact of tax reductions on work effort, risk-taking, and saving can be ambiguous.

[30] See the summaries of the relevant literatures in Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform* (MIT Press: Cambridge, 1996).

[31] More precisely, higher national saving today increases national income in the future regardless of whether the increase in national saving is absorbed in higher domestic investment or net foreign investment. In the latter case, the increase in future income would reflect an increase in receipts from abroad (relative to the baseline), rather than an increase in domestic output.

[32] For a specific application in the context of the recent budget debates, see Peter R. Orszag, "The Budget and Long-term Fiscal Policy," Committee on the Budget, U.S. Senate, February 7, 2001.

[33] These estimates apply to EGTRRA as a whole. But even if *all* the positive long-run benefits from EGTRRA arose from the tax cuts that are not yet in effect—which is clearly a gross overestimate of the economic benefits from those future tax cuts—the net effect of those future tax cuts on the economy in the long run would still be roughly zero. In other words, the available evidence suggests that the long-run economic gains from the future tax cuts would be minimal at best, because the adverse effects from reduced national saving offset the beneficial effects from reduced tax rates.

[34] Peter R. Orszag, "Marginal Tax Rate Reductions and the Economy: What Would Be The Long-Term Effects of the Bush Tax Cut?" Center on Budget and Policy Priorities, March 15, 2001.

small to offset the costs of the fall in national saving. The Congressional Budget Office has similarly concluded, "The cumulative effects of the new tax law on the economy are uncertain but will probably be small. Labor supply may rise modestly as a result of the reductions in marginal tax rates (the rates that apply to the last dollar earned); however, national saving may fall. Whether the tax cut will raise or lower real (inflation-adjusted) gross domestic product (GDP) in the long run is unknown, but any effect is likely to be less than half of a percentage point in 2011."[35] Finally, an authoritative examination of the tax legislation by William Gale and Samara Potter of Brookings has concluded that the overall impact on economic activity in the long run will be minimal, and may well be negative.[36]

Budget effects in the long run

In addition to its long-term economic effects, we should consider the impact of the future tax reductions on the budget itself. As Director Crippen emphasized in recent testimony before this committee, budgetary pressures are severe over the longer term. As he noted, "long-term pressures on spending loom just over the horizon. . . According to midrange estimates, if current policies continue, spending on Social Security, Medicare, and Medicaid combined will nearly double by 2030, to almost 15 percent of GDP. Taking action sooner rather than later to address long-term budgetary pressures can make a significant difference."[37]

The tax cuts scheduled for the future under EGTRRA, assuming they are continued after 2010, are large relative to the projected fiscal gaps over the next 70 to 75 years. Economists define the "fiscal gap" as the magnitude of the immediate and permanent increase in taxes or reduction in primary expenditures that would be required to keep the long-run ratio of government debt to GDP at its current level given other current policies. In other words, the fiscal gap basically measures the projected long-term imbalance in the budget as a share of GDP.

Alan Auerbach of the University of California at Berkeley and William Gale of Brookings have estimated the fiscal gap through 2070 using CBO baseline assumptions about discretionary spending (which assume that discretionary spending remains constant in real terms for the next decade and then remain constant as a share of GDP thereafter).[38] Before passage of EGTRRA, Auerbach and Gale estimated that the fiscal gap through 2070 amounts to 0.67 percent of GDP.[39] The provisions of the tax cut that have already been implemented more than double that gap, to about 1.5 percent of GDP. The tax cuts scheduled for the future would raise it still further, to about 2.3 percent of GDP.

In other words, the tax cuts scheduled for the future would increase the long-term fiscal gap from about 1.5 percent of GDP to about 2.3 percent of GDP. To be sure, these types of calculations are subject to substantial uncertainty. But such uncertainty does not change the basic conclusion that the scheduled tax cuts represent a significant share of the Nation's long-term fiscal imbalance. In any case, uncertainty should make us even more hesitant to proceed with policy changes that significantly reduce revenue or raise expenditures.[40]

Another perspective on the cost of the tax cuts scheduled for the future is that their cost over the next 75 years—about 0.8 percent of GDP—is slightly larger than the projected imbalance in Social Security over the same period.[41] According to the Social Security actuaries, the 75-year projected deficit in Social Security (under the intermediate cost assumptions) amounts to roughly 0.7 percent of GDP. In other words, freezing the future tax cuts and using the funds instead as general revenue transfers to the Social Security System would eliminate the deficit in Social Security

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[35] Congressional Budget Office, "The Long-Term Macroeconomic Effects of the Economic Growth and Tax Relief Reconciliation Act of 2001," Box 2–3, *The Budget and Economic Outlook. An Update*, August 2001.

[36] William G. Gale and Samara R. Potter, "An Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," forthcoming, National Tax Journal.

[37] Daniel Crippen, "The Budget and Economic Outlook: Fiscal Years 2003–2012," Testimony before the Committee on the Budget, U.S. Senate, January 23, 2002.

[38] Alan J. Auerbach and William G. Gale, "Tax Cuts atid the Budget," Tax Notes 90, March 26, 2001, pages 1869- 82.

[39] This figure is subject to substantial uncertainty. For example, it is extremely sensitive to assumptions about discretionary spending trends: Assuming that discretionary spending would remain constant as a share of GDP from today forward, rather than only from 2011 forward, raises the fiscal gap to 1.45 percent of GDP over the next 70 years.

[40] See, for example, Alan Auerbach and Kevin Hassett, "Uncertainty and the Design of Long-Run Fiscal Policy," NBER Working Paper 7036, March 1999.

[41] For more on comparing the tax cut and the long-term deficit in Social Security, see Richard Kogan, Robert Greenstein, and Peter Orszag, "Social Security and the Tax Cut," Center on Budget and Policy Priorities, Revised December 13, 2001.

over the next 75 years.[42] To be clear, I am not advocating such a policy as the only "solution" to addressing Social Security's deficit, but it does help to put the size of the scheduled tax cuts in perspective.

The Social Security comparison also helps to highlight a crucial distributional concern:

The tax cuts scheduled for the future will accrue disproportionately to higher-income taxpayers. Yet the budget cuts that may be required if the tax cuts are implemented would likely be borne disproportionately by lower-income and middle-income families.

CONCLUSION

In conclusion, the tax cuts scheduled for the future are likely restraining the economic recovery in the short run—by keeping long-term rates higher than they would otherwise be—and they would do little to boost economic output in the long run because any positive incentive effects would be offset by reduced national saving. They would also add significantly to the long-term budget challenge facing the Nation.

Let me therefore put forward a possible compromise that my colleague William Gale and I have advocated. The tax cuts embodied in EGTRRA expire in 2010. The debate at this point is whether those cuts should be restricted or made permanent. Senator Kennedy recently proposed that some of the already-legislated future tax cuts for high-income households be frozen to help pay for a variety of social programs. The Administration, however, opposes any trimming of the tax cut and instead wants to make the tax cuts permanent.

Here are two things that both sides would have to agree upon:

- First, whatever one thought about whether the tax cuts were affordable last year, it has to be the case that they are less affordable now. After all, since then, the economic outlook has soured, homeland security and anti-terrorism spending needs have become apparent, and budget surpluses have withered.
- Second, the tax cuts that have already been implemented will be extremely difficult to reverse, even when they officially sunset in 2010.

In light of these lonely points of agreement, allow me to put forward a simple compromise: Make the tax cuts that are already in place permanent, but postpone the other ones until they are affordable. The artificial sunsets of the tax cuts that are already in effect should be removed. But none of the future tax cuts should be allowed to take effect until they are affordable. Specifically, any tax cuts not yet in effect should be frozen until the projected 10-year budget surplus outside of Social Security and Medicare grows to be at least as large (relative to the economy) as it was immediately following passage of the tax cut.

Since about half of the tax cuts are already in effect, the result gives each side of the tax debate half of what it wants: Half of the tax cut would be made permanent, and half would be frozen until it was clearly affordable. Freezing the future tax cuts until they are affordable—while also making the existing tax cuts permanent—would thus offer a little to both sides. And it would help to end the budget charade that has confused the debate over the Nation's political and economic choices.

Year-by-Year Provisions Under the Economic Growth and Tax Relief Reconciliation Act of 2001

2001

- New 10 percent income tax bracket on the first $12,000 in taxable income for couples, $10,000 for single parents and $6,000 for others (no indexing for inflation).
- Income tax rates of 39.6 percent, 36 percent, 31 percent and 28 percent each reduced by 1 percentage point, effective July 1, 2001—in essence, a half point reduction for calendar 2001.
- Child credit increased from $500 to $600, with expanded refundability based on 10 percent of earnings above $10,000 (the $10,000 figure is adjusted in future years for inflation).

[42] Under the Social Security actuaries' intermediate projections, the projected 75-year deficit amounts to 1.86 percent of taxable payroll. Over this 75-year-period, taxable payroll will amount to 37.6 percent of the Gross Domestic Product when both are expressed in present value. As a result, the 75-year imbalance amounts to 0.7 percent of GDP, which is equal to 1.86 percent of taxable payroll multiplied by 37.6 percent. The figure of 0.7 percent of GDP appears in Table VI.E5 on page 150 of the Trustees Report of March 19, 2001.

2002

- Earned-income tax credit phase-out range increased by $1,000 for married couples ($1,000 is not indexed).
- Maximum expenses for child-care and maid-service credit raised from $2,400 to $3,000 for one child under 13 and from $4,800 to $6,000 for two or more children under 13; maximum credit rate increased from 30 percent to 35 percent; credit rate phased down to 20 percent between $15,001 and $43,001 in income rather than from $10,001 to $28,001.
- IRA annual contribution limit increased to $3,000 (from $2,000). Limit on elective deferrals raised from $10,000 to $11,000. Other retirement savings changes take effect.IRA tax credits for lower-income workers established.
- Alternative minimum tax exemptions increased by $4,000 for couples and $2,000 for singles.
- Top estate tax rate cut from 55 percent to 50 percent; recapture of lower rates repealed; estate tax credit converted to an exemption (worth more for larger estates) and exemption increased from $700,000 to $1 million (double those amounts for couples).

2003

- Limit on elective retirement savings deferrals raised from $11,000 to $12,000.
- Top estate tax rate cut to 49 percent

2004

- Top four income tax rates cut by an additional percentage point (to 37.6 percent, 34 percent, 29 percent and 27 percent).
- Limit on elective retirement savings deferrals raised from $12,000 to $13,000.
- Top estate tax rate cut to 48 percent. Exemption increased to $1.5 million (double that for couples).

2005

- Child credit increased to $700, with further expansion in refundability, based on 15 percent of earnings above about $12,000 (the $12,000 figure will be adjusted for inflation in later years).
- Earned-income tax credit phase-out range increased by an additional $1,000 for married couples ($2,000 total increase is not indexed for inflation).
- Married standard deduction increased to 174 percent of the single amount (up from 167 percent).
- Starting point for the 26 percent tax bracket for couples increased to 180 percent of the single bracket starting point (up from 167 percent under prior law).
- IRA annual contribution limit increased to $4,000. Limit on elective deferrals raised to $14,000.
- Alternative minimum tax exemptions reduced by $4,000 for couples and $2,000 for singles.
- Top estate tax rate cut to 47 percent

2006

- Top four income tax rates cut to 35 percent, 33 percent, 28 percent and 25 percent.
- Starting point for the 25 percent tax bracket for couples increased to 187 percent of the single bracket starting point.
- Married standard deduction increased to 184 percent of the single amount.
- Limit on elective retirement savings deferrals raised to $15,000 (indexed thereafter).
- Current law's phase-out of the personal exemption and disallowance of a portion of itemized deductions at high income levels are reduced by one-third.
- Top estate tax rate cut to 46 percent. Exemption increased to $2 million (double that for couples).

2007

- Starting point for the 25 percent tax bracket increased for couples, to 193 percent of the single bracket starting point.
- Married standard deduction increased to 187 percent of the single amount.
- IRA tax credits for lower-income workers eliminated.
- Top estate tax rate cut to 45 percent.

2008

- Earned-income tax credit phase-out range increased by an additional $1,000 for married couples ($3,000 total increase is indexed for inflation after 2008).
- Income amounts for the 10-percent tax bracket increased to $14,000 for couples and $7,000 for childless singles ($10,000 for single parents remains unchanged). Indexed for inflation starting the following year.
- Married standard deduction increased to 193 percent of the single amount.
- Starting point for the 25 percent tax bracket for couples increased to double the single bracket starting point.
- IRA annual contribution limit increased to $5,000 (indexed thereafter).
- Current law's phase-out of the personal exemption and disallowance of a portion of itemized deductions at high income levels are reduced by two-thirds.

2009

- Child credit increased to $800.
- Married standard deduction increased to double of the single amount.
- Estate tax exemption increased to $3.5 million (double that for couples).

2010

- Child credit increased to $1,000 (no indexing for inflation).
- Current law's phaseout of the personal exemption and disallowance of a portion of itemized deductions at high income levels are fully repealed.
- Estate tax fully repealed (gift tax retained; limited carryover basis).

Source: Citizens for Tax Justice

Chairman CONRAD. Mr. Wesbury, welcome to you as well. It is good to have you back before the committee. We appreciate your taking the time to be here.

Please proceed.

STATEMENT OF BRIAN S. WESBURY, CHIEF ECONOMIST, GRIFFIN, KUBIK, STEPHENS & THOMPSON, INC.

Mr. WESBURY. Thank you, Mr. Chairman and members of the committee. It is good to be here this morning to discuss the budget and the economy.

I would like to request that my written testimony be submitted for the record, and I will summarize that this morning.

Chairman CONRAD. Without objection, that will be the case for all the witnesses. Written statements will be made a full part of the record, and we appreciate your willingness to summarize.

Mr. WESBURY. Thank you very much.

As we all know and as has been discussed here this morning, there have been many dramatic changes in the budget, monetary policy and the economy in the past year. We had a 120-month-long recovery that ended in March of 2001. The Federal Reserve cut interest rates 11 times; as far as I can tell, that is a record in the last 40 years. And in addition, as we all know, the budget has changed dramatically, and we have swung from over $300 billion surpluses in 2002 to 2003 to expected deficits at this point.

Together, all of these things are almost impossible to analyze because each one of them affects each other. We have an intertwined economy.

But one thing we can say for certain, I think, is that if we had not entered recession in 2001, the budget would still be in surplus today. According to the CBO, total economic changes will subtract $148 billion from the surplus in 2002 and $131 billion in 2003. Their forecasts of deficits right now are $21 and $14 billion in those 2 years, and as a result, we would have surpluses of over $100 billion in each year, 2002 or 2003, if it were not for the recession.

As a result, I think it is important for us to go back and look at what caused the recession. There are four basic theories about the cause of the recession today. Some believe that our recession is just an inventory correction or possibly caused by the attacks of September 11. Others believe that our recession is a bursting bubble of irrational exuberance and overinvestment, and that it was bound to happen regardless of what anyone did.

One other explanation for our current recession is that the tax cut drove up interest rates, which slowed down our economy and created a recession out of what would have been a slowing economy.

There is a final reason or thought about what caused the recession, and this is the one that I subscribe to—that our current recession has been caused by what I would call "policy mistakes." That is, in 1999 and 2000, the Federal Reserve drove up interest rates to excessively high levels, and at the same time, in 2000, taxes reached a record share of GDP—20.8 percent of GDP. The last time we saw taxes at anywhere near that level was in 1944, and the peak then during World War II was 20.9 percent of GDP. So we almost hit a record level of taxes as a share of GDP in 2000.

When you combine high real interest rates and high taxes, I do not know of an economy in the world that can stand up to those kinds of problems. As a result, I think we ended up in a recession today.

Just to quickly go through some of the characteristics of the recession, industrial production peaked in the middle of 2000, well before the tax cut in May of 2001, well before the March 2001 starting date of the recession according to the National Bureau of Economic Research.

Consumption, however, has stayed pretty strong, and I think there are a few reasons for that. Number one, we have countercyclical government spending programs in place. Unemployment insurance did go up. People filed for unemployment, and their incomes did not go to zero. In addition, privately funded or private companies gave very large severences early in the recession to the people that they laid off, and as a result once again, consumption and incomes did not drop to zero once a person was laid off.

What is interesting about our current recession is that the strongest area of the economy in the past year has been housing. In fact, while many people may not know it, existing home sales hit a record high level, an all-time record high, in 2001. New home sales were also very high, I think at their second-highest total on record in 2001.

I would like to point out one fact about that that I think is often overlooked. In 1997, the tax bill of that year virtually eradicated capital gains taxes on home sales. Up to $500,000 in a gain per couple in a home that has been lived in for 2 years can now be taken tax-free. And interestingly enough, those lower taxes have created a boom in the housing market, and I think are one of the reasons why the housing market has been so strong throughout this recession.

As a result, one of the things that I think is true about the future is that we need to do everything we can to keep tax rates and taxes as low as possible. Not only are the areas that face low taxes strong, but I believe that high taxes played a major part in the creation of our current recession.

Growth is the key to our future, and this is kind of interesting, because when growth occurs, deficits tend to disappear and come to surplus. In fact, I think that is the story of the late 1990's.

What is interesting is that now, as we are turning to deficits—I would like to focus on this for just a second—it used to be that economists would talk about deficits as being stimulative to the economy, and in fact, in periods of war or in periods of recession, it was highly suggested and recommended by most economists to run deficits to stimulate the economy, the thought being that that investment would pay huge dividends down the road, either bringing the economy out of recession or protecting the United States.

Lately, however, in the last 10 to 15 years, this correlation between deficits and interest rates has become the model that most economists follow. While we have heard a number of times this morning that deficits play a big role in interest rates, I would like to suggest this morning that I do not believe that that is true at all. I am a professional in the bond business, and I have been an economist in the private sector for 20 years, I have followed the bond market and its relationship to deficits, and I find absolutely no relationship between the two.

Let me give you some numbers. In January 1981, when Ronald Reagan took office, mortgage rates in our economy were at 14.9 percent. In January 1993, when President George Bush 41 left office, mortgage rates were at 8 percent. We basically had a 7 percentage point decline in mortgage rates in those 12 years, and deficits existed in each and every one of those years.

When President Clinton left office in January of 2001, mortgage rates were at 7 percent. They had declined only 1 percentage points in the 8 years of his term in office, despite the budget moving from deficit to surplus.

Some people will say—and Alan Greenspan is very careful to say this—that real interest rate are the key. I would just like to give you two specific points on this. Between 1981 and 1983, when the budget deficit averaged 3.1 percent of GDP, real 30-year mortgage rates were at 8 percent. By 1993, when the budget deficit was 3.9 percent—in fact, it was higher as a share of GDP than it was in the 1981 to 1983 period—real interest rates had fallen from 5.6 down to 4 percent.

I have a chart in my testimony that shows real interest rates, and they basically remain unchanged, with some small movements up and down, over the past 10 years, despite the budget going from deficit to surplus. I find absolutely no theoretical evidence to support the contention that deficits raise interest rates over time.

Let me move forward and close very quickly and suggest to you that I believe our economy is on the verge of recovery. The interest rate cuts of this past year, the tax cuts of May 2001, are benefiting the economy as we move forward. My belief is that if we were to repeal those tax cuts, we would harm the economy and slow the recovery dramatically. The way to keep the deficit away and surpluses intact in the future is to keep growth up, and I believe that the way to do that is to cut taxes and allow the private sector to do its job.

Thank you.

[The prepared statement of Mr. Wesbury follows:]

THE PREPARED STATEMENT OF BRIAN S. WESBURY, CHIEF ECONOMIST, GRIFFIN, KUBIK, STEPHENS & THOMPSON, INC.[1]

Mr. Chairman, Senator Domenici, and members of the committee, I am pleased to be here today to discuss issues surrounding the economy and the Federal budget. I would like to emphasize that I speak for myself and not my employer, Griffin, Kubik, Stephens & Thompson, Inc.

The past year has witnessed some dramatic changes in the economy, the budget and monetary policy. After expanding for 120-consecutive months, the longest period of sustained growth in U.S. history, the economy entered recession in March 2001. In reaction to the slowdown, the Federal Reserve cut interest rates eleven times in 2001, the sharpest drop in rates in over 40 years.

In addition, both short-term and long-term estimates of the budget surplus underwent significant revisions. In May 2001, the Congressional Budget Office estimated that the surplus for 2001 would equal $275 billion. Just 4 months later, the figures show that the actual surplus was $127 billion. At the same time, expected surpluses of over $300 billion in 2002 and 2003 have given way to certain deficits. The recession, higher spending, and tax cuts reduced the 10-year estimate of the budget surplus from $5.6 trillion to $1.6 trillion.

Analyzing these developments individually is impossible. The economy, the Federal Reserve and the budget are inseparably intertwined. The economy affects monetary and fiscal policy, while monetary and fiscal policy exert a large influence on the economy.

For example, according to CBO analysis, the recession will reduce revenues and increase expenditures by a total of $148 billion in 2002 and $131 billion in 2003. At the same time, the CBO estimates that deficits will equal $21 billion in 2002 and just $14 billion in 2003. Clearly, the economy would have experienced surpluses in both years if the recession had not occurred.

THE CAUSES OF THE CURRENT RECESSION

As a result, it is important to understand how the recession began. In this regard, there are at least four different explanations of the current downturn. Some suggest that it is a simple inventory correction made worse by the attacks of September 11. Others suggest that our current recession is the result of a bursting bubble of irrational exuberance and over-investment.

Still others suggest that the tax cut of early last year, because it lowered the surplus and drove up interest rates, either caused the recession or made it worse. Finally, there are some who think that the recession was caused by policy mistakes. I include myself in this final group. High taxes and excessively tight monetary policy in 2000 are the real culprits behind our current economic downturn. In fact, it was the impact of these policies that led to my forecast in January 2001 that the United States would experience its first recession in 10 years.

In 2000, the Federal Reserve increased real interest rates to their highest level since 1989/1990. High real interest rates were the visible evidence of an excessively tight monetary policy that created deflationary pressures. These deflationary pressures, evident in so many industries, undermined corporate profits and investment. At the same time tight money was creating havoc, Federal revenues rose to 20.8 percent of GDP in 2000, a peacetime record.

History shows that the combination of tight monetary policy and burdensome taxes eventually creates a recession. This was true in 1990/91, in the early 1980's and also in Japan during the 1990's. High taxes reduce the capital available for investment, undermine incentives for research and development, and reduce output, while tight money robs the system of liquidity.

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[1] Brian S. Wesbury is the Chief Economist of Griffin, Kubik, Stephens & Thompson, Inc. a Chicago-based investment banking firm. Mr. Wesbury previously served as Chief Economist for the Joint Economic Committee of Congress in 1995 and 1996.

CHARACTERISTICS OF THE RECESSION

Industrial production peaked in June 2000 almost a year before the recession officially began and well before the tax cut passed in May 2001. Employment peaked in March 2001 also well before the tax cut. Consumption slowed sharply in late 2000 and early 2001, but did not dip into negative territory until late 2001. Interestingly, housing activity remains very strong and existing homes sold at a record level in 2001.

The areas of weakness and strength in the economy during the past year are somewhat instructive. Consumption did not fall as much as rising unemployment suggested it should because counter-cyclical policies worked. Unemployment insurance kept incomes from falling to zero and tax rebates added to near-term purchasing power. In addition, large, privately funded severance packages for many of those laid-off early in the recession kept incomes from falling.

Strength in housing is a different story. Housing is one of the only tax-free investment vehicles available to Americans today. Due to changes made in the tax code in 1997, up to $500,000 in gains on the sale of a home, for a couple who has lived in that home for 2 years or more, are tax free. Mortgage interest is deductible from taxes as well. Beginning in May 1997, new and existing home sales shot upward and have literally defied demographic trends. Judging from this evidence it can be said that tax cuts do increase economic activity.

To summarize, the recession was not caused by tax cuts, a bursting bubble, a drop in consumer confidence due to terrorist attacks, or an inventory correction. It was caused by policy mistakes, specifically, high taxes and an excessively tight monetary policy. In turn, the recession created our budget deficits.

FOCUS ON GROWTH, NOT DEFICITS

Growth is the key to all budgetary and economic problems. And, in my opinion, historical evidence shows that countries with lower taxes and less spending grow faster than countries with high taxes and large governments. I believe the goal of fiscal policy should be to maximize the potential of the private sector to create jobs and wealth. And even if the ultimate goal is to eliminate Federal deficits and debt, the best way to achieve that goal is by encouraging growth.

Historically, in periods of recession or war, economists have suggested that deficits are appropriate. In laymen's terms, running a deficit (or borrowing money) is an investment in the future of the economy. If that investment keeps our Nation safe from foreign attack or ends a recession, then the returns from that investment should outweigh the costs. However, in recent decades many economists have suggested that deficits have a detrimental effect on the economy because they push up interest rates.

Despite the near universal acceptance of this theory, I find no evidence to support it. During the past 20 years, the Federal budget has moved from record deficits to record surpluses, but interest rates have not moved in the direction suggested by the deficit theory. For example, in January 1981, when Ronald Reagan became President, 30-year mortgage rates were 14.9 percent. Twelve years later, when George Bush left office and Bill Clinton became President, the 30-year mortgage rate was 8.0 percent. The economy experienced deficits in each of those 12 years, yet mortgage rates fell by a total of 7 percentage points.

When Bill Clinton left office in January 2001, the 30-year mortgage rate was 7.0 percent a decline of just 1 percentage point during his 8-year tenure. This small drop pales in comparison to the declines of the 1980's, despite record budget surpluses. The evidence suggests that there is no relationship between budget deficits and interest rates over long periods of time. (See Chart 1).

The same is true if we analyze real (or inflation adjusted) interest rates. Between 1981 and 1983, budget deficits average 3.1 percent of GDP and the real 30-year mortgage rate averaged 8.0 percent. In 1993, the deficit was 3.9 percent of GDP and the real 30-year mortgage rate was 4.0 percent. In 2000, when the surplus reached a record 2.4 percent of GDP, real 30-year mortgage rates were 5.6 percent. And, in 2001, as the budget moved toward deficit, real mortgage rates fell back to 4.0 percent. (See Chart 2).

Chart #1

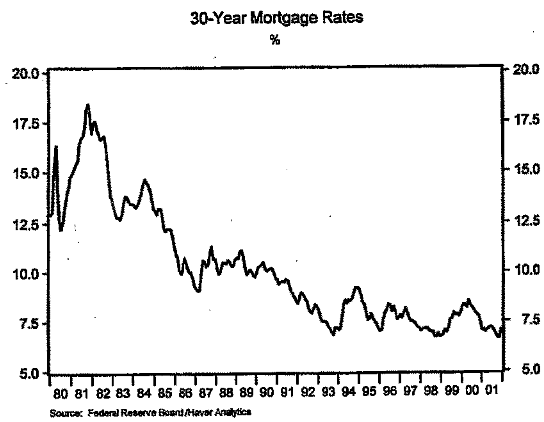
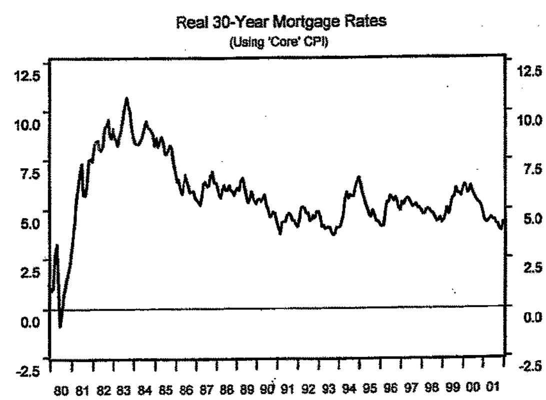


Chart #2



TAX CUTS ARE KEY

Economic growth rates also show little correlation to movements in the deficit. The U.S. economy rebounded strongly from the early 1980's recessions even though deficits were high, and real GDP grew at a 4.4 percent annual rate between 1982 and 1987. Between 1995 and 2000, despite moving from deficits to surpluses, real GDP grew at a slower 4.1 percent rate. In addition, the economy fell into recession in early 2001 despite a budget surplus.

The driving force behind growth in both the 1980's and 1990's was the same high-tech investment and productivity. And, in my opinion, the shift in government policy that began during the late 1970's and accelerated in the early 1980's was the catalyst behind our long boom. Reduced marginal income tax rates, lower capital gains tax rates, and falling government spending as a share of GDP created a better environment for entrepreneurial success. As a result, the United States became the focal point of the information revolution and we have experienced two of the longest recoveries on our history during the past 20 years.

In fact, it has been over 100 years since the United States experienced productivity growth as strong as we have seen in recent years. And according to my calculations, productivity growth reached higher levels in the late 1990's than it did in the Industrial Revolution. More importantly, the world is just beginning this revolution in technology. It has a long way to run.

Anything the government can do to help increase incentives for creativity, innovation and investment will pay huge dividends down the road. In that regard, it is my advice that tax rates be kept as low as possible, spending increases should remain minimal and any concerns over the deficit should wait until after the United States exits this recession and has a chance to grow again.

The Bush tax cuts of 2001 were perfectly timed to help the economy in the years ahead. However, because they were phased in over a decade-long period they have only been a small help to the economy in the past year. It is my strong belief that the economy would already be in recovery if the Bush tax cuts had been fully effective in 2001.

But that is water under the bridge, and we must look forward. Repealing the tax cut would be a huge mistake and could undermine the recovery already taking hold. I expect this recovery to start out slower than past recoveries, but build steam as 2002 unfolds. In 2003, the economy should once again grow at a 4.0 percent rate or higher. Unemployment will fall, tax revenues will pick up, counter-cyclical government spending will subside and the budget picture will brighten.

In other words, despite the mistakes made in the past year, the economy remains on sound footing. As taxes head lower, foreign investment will continue to flow toward the United States, technology will continue to advance and living standards will rise.

We are living through an exceptional period in history, and we should attempt, as best we can, to have faith in the American system of free markets. The entrepreneurial spirit remains strong and as history shows, the less the government interferes, the better. In fact, doing everything possible to reduce burdens on the private sector increases growth, and in turn, boosts the resources of government. What creates growth in the private sector is ultimately good for the public sector.

Chairman CONRAD. Thank you all for excellent testimony. It is good to see the witnesses in such close agreement. [Laughter.]

It was really excellent testimony from all three of you. What makes our system great is that we have the ability to debate these differences, and we can debate them freely and even vigorously. That is the health of our country, and we are lucky for it; we are lucky to have people like you who are willing to come before the committee and give your strong views. That is helpful to us, and we appreciate it very much.

Dr. Reischauer, I would like to start with you, and I am going to be very brief in my questioning because I know that Senator Clinton has an obligation to chair at 11 o'clock, and Senator Corzine is next, and he has been in the bond business, and he has a different view, and I am sure we will get to that.

Dr. Reischauer, you are saying to us, number 1, that we ought to set a goal and try to achieve consensus on what that goal should be. You are talking about something like respecting the Social Security Trust Fund as a possible goal and one that you say would have some political strength to it, and I believe that. I think that is an appropriate goal.

You suggest that in the near term, to create more fiscal flexibility, we ought to consider deferring parts of the tax cut that have not yet occurred, but on the other hand, make permanent those parts that already have occurred and actually index them.

Is that a correct interpretation of what you said?

Mr. REISCHAUER. That is correct.

Chairman CONRAD. And Mr. Wesbury says no, you should not be doing that because that will harm the economy, as I hear Mr. Wesbury's testimony.

What would your answer be to his assertion?

Mr. REISCHAUER. That prospective reductions in taxes that may not be affordable really offer no strength to the current economy right now. There is a tremendous amount of uncertainty out there, and that uncertainty as to just what we do about the provisions of this tax bill is going to grow over the next few years, as to just what we will do about the provisions of this tax bill, because the tax bill disappears in effect at the end of 2010. The costs of continuing it rise through time, and at the same time, as Peter told you, the available resources just do not seem to be there. I think that with each year that goes by, it will become more apparent that if the tax cut is extended in all of its full flower, we will be in effect using the Social Security surplus to pay for tax relief, and that will be a very difficult decision for future Congresses to make.

Chairman CONRAD. So what if we are? If the evidence emerges, and it becomes even more clear that we are taking, in effect, Social Security Trust Fund dollars to pay for the tax cut, so what?

Mr. REISCHAUER. Well, we are making a decision then that we would rather have lower tax rates now and higher tax burdens on our children and grandchildren, and a more contentious process of trying to accommodate the retirement of the baby boom generation one decade and two decades from now—the choices that you make all the time between the present and the future. It would seem to me that the appropriate one—although this is a value judgment—is to say that we want to help our children and grandchildren bear the burden which our decisions are imposing on them.

Chairman CONRAD. Is there a fairness question of taking people's payroll tax dollars, which are imposed on what most economists would say is a regressive basis, and using those dollars to give an income tax cut that goes disproportionately to the wealthiest among us? Do you think there is any problem with that?

Mr. REISCHAUER. This is a complicated issue. I think that there really is not an issue unless you think that we will not respect the trust fund balances that are building up in Social Security.

In other words, I think that as long as there are balances that are large, it will be very hard to cut benefits or raise payroll taxes, and what this is doing is substituting, really, for other borrowing.

Chairman CONRAD. Dr. Orszag, you have said here that there is a connection, as I heard your testimony and as I read your testimony, between interest rates, and deficits, and the debt of the Federal Government. Is that correct?

Mr. ORSZAG. That is correct, and I will note again that it is not just me, but the Reagan administration, the first Bush administration, and a whole host of others.

Chairman CONRAD. So where do you think Mr. Wesbury goes wrong in his analysis? He has given a very compelling case here this morning. He has looked at past points where we had high deficits, high as a percentage of GDP, and yet interest rates were coming down, so he looks at the data—I assume the same data—and reaches a different conclusion.

Can you help us understand?

Mr. ORSZAG. Sure. I think the difficulty here is that as I mentioned in my testimony, interest rates are affected by a wide variety of factors including expected growth, savings trends, capital flows, and expected inflation. All of those things are moving at the same time.

If you just look at one point in time and another point in time and say, oh, look, the deficit moved and interest rates did not move in the expected way, you have to make sure that you have controlled for all those other factors or else you are not isolating the impact of the budget itself on interest rates.

After you control for all those other factors, which is admittedly a very difficult thing to do, market observers as well as the economists who pyt together macroeconomc models peceive a relationship between budget deficits and interest rates. The key is to isolate all the other factors, all the other things that are changingm and just lok at the shift in the budget deficit itself. Examining just two points in time, without adjusting for the other factors that are moving, is not valid because other factors are changing at the same time.

When you do that—and that is a very difficult thing to do—but again in the judgment of many market observers and also the people who put together the macroeconomic models that you use here to base your budgets on, there is a connection there, so that once you isolate all the other effects, all the other things that are changing, and just look at the impact of the shift in the budget itself, there is a connection between that and interest rates and you get messed up when you just look at two points in time, because everything is changing at the same time.

Chairman CONRAD. OK.

Mr. Wesbury, you are not saying that deficits do not matter, and you are not saying—well, let me not put words in your mouth. I assume that you are not saying that deficits do not matter, but is that the case? Do you believe that budget deficits matter, and if so, how, and if not, why not?

Mr. WESBURY. Let me put it this way. I think deficits matter a whole lot less than much of my economic brethren believe. For example, if we just look at Japan very quickly, they have a debt of over 130 percent of GDP, they are running deficits of 6 and 7 percent of GDP every year, and yet their long-term interest rates are 1.5 percent, their short-term interest rates are zero, and their economy is in recession.

Bottom line, when you look at that fact, deficits do not stimulate the economy, because they have not held Japan, and they do not hold up interest rates, because they are the lowest in the world.

So at least when I look around the world, I see no correlation between deficits and the level of interest rates in different countries or deficits and differing growth rates in different countries.

Chairman CONRAD. Do deficits matter for any other reason?

Mr. WESBURY. In fact, I think that what we should focus on over time is how to get the most growth in our economy. I think Milton Friedman used to put it this way. If we had a $10 trillion economy, and the government spent $8 trillion, 80 percent of that economy—so it would be equivalent, I suppose, tot he Soviet Union—and yet we took in taxes of $8 trillion at the same time, we would have a balanced budget, but we would probably have the same problems in our economy that the Soviet Union did—no growth, declining standards of living, falling productivity. Yet if we had a government in that same $10 trillion economy who spent only $200 billion but to zero in taxes, we would be running a $200 billion deficit. I think you would agree with my analysis here, which really comes from Milton Friedman, that that would be an entirely different economy and I would argue a much stronger economy over time.

So the point is that just by looking at the deficit, we are forgetting if we just focus on that one number what created that deficit or the surplus or the balanced budget to begin with. And as a result, my belief is that what we need to focus on is the level of spending and where that spending is taking place, and we need to focus on the tax rates and the level of taxation in the economy and how they are affecting our output, incentives, willingness to be creative, and how they affect our entrepreneurial base. That is what I think is important.

Chairman CONRAD. OK. Dr. Orszag, what would your response be?

Mr. ORSZAG. Well, I actually think the Japanese example illustrates the basic problem here. Japan, in addition to running fiscal deficits, has a very high private savings rate. You have different projected demographics in Japan. There are a lot of things that vary between the United States and Japan. Just to look at one indicator and attribute all the interest rate differentials to that one indicator I think illustrates my point, which is that such analysis is unlikely to be valid.

I would also agree that economic growth is essential to addressing many of the problems that the Nation faces. The key question is how are you going to get that economic growth. One thing you need to remember in evaluating these tax cuts, even in the long run, is that it is not clear that their net impact is positive. Again I will refer you to the Congressional Budget Office. You do have positive effects from lower marginal tax rates encouraging people to work, but the tax legislation only reduces marginal tax rates for about a quarter of the population. For 76 percent of tax filing units, this tax legislation does not affect marginal tax rates.

Furthermore, you have the reduction in national saving, and that reduction in national saving adversely affects the economy by, again, driving up interest rates and harming investment. So it is the interplay between those two effects that determines the long run effects from the tax cut. It is not at all clear that the impact is positive. I concluded earlier last year that the impact may well be negative. The CBO suggests that it is not clear; it may well be negative. A new paper that my colleague Bill Gale from Brookings is putting out suggest that, if anything, the effect is negative.

So I agree that the key question is economic growth, but it is not clear that cutting taxes is the right way to get there.

Chairman CONRAD. Dr. Reischauer, what would your response be to Mr. Wesbury's analysis? Do you agree that economic growth is the key that we are shooting for?

Mr. REISCHAUER. Certainly it is; there is no question. But my response would be let us look at the decade of the 1990's. We had a period of very strong growth, a period in which tax burdens were increased in an effort to bring down deficits, and a period in which, surprisingly, the fraction of GDP devoted to Federal expenditures fell.

So I say bring back the 1990's; do not try to recreate, literally, the 1980's.

Chairman CONRAD. All right. I am going to go to Senator Corzine now—Senator Clinton, do you preside at 11?

Senator CLINTON. I do. I am going to have to leave.

Senator CORZINE. Why don't you go ahead?

Chairman CONRAD. Why don't we recognize you, then, at this time for questions that you might have?

Senator CLINTON. Thank you, Mr. Chairman, and I thank our witnesses and appreciate the interchange that we have had. I think that is something that we should do more of, to have our witnesses respond to one another, because I think it helps to clarify a lot of these issues.

I would have to say that there is a very big difference of opinions not only among the witnesses, or between two and Mr. Wesbury, but also on this committee and I think in our Congress and throughout the country as to what is the best way to stimulate economic growth. That is what we are interested in. What we want is a growing economy that enables even more people to work, creates the conditions for rising incomes. In looking at some of the statistics about Federal revenues being a high percentage of GDP, I think that, again, as Dr. Orszag reminds us, we cannot take any statistic out of context, because certainly median family income rose by over $6,000 over adjusting for inflation between 1993 and 2000. There were significant bonuses, not only in the financial services sector, but in many sectors of the economy, that pushed people's income tax burden higher.

Indeed, though, Federal income taxes as a percentage of income for the typical American family dropped to their lowest level in 35 years. Now, this is not an argument for keeping tax rates higher than they need to be. I, among many of my colleagues, argued for a balanced tax reduction last spring. What I think we are concerned about is the impact of this large tax cut and the way that it was configured.

So I guess my question, to go back to what is for me the most important issue, is what is it that we are trying to achieve. We are trying to achieve economic growth, and I think we should be trying to achieve some ability to deal with problems that we know are on the horizon. And the best way to do that is through growth and fiscal responsibility to be prepared.

So I will just ask each of the witnesses, perhaps beginning with Mr. Wesbury, because I know that your view is different, as you look forward—and I do have to leave soon—as you look forward, Mr. Wesbury, and you see the demographic inevitability—I do not think there is any debate about that; we are going to have increasing calls on Social Security, Medicare, and other services that an aging population requires—how would you best prepare our country to deal with those problems?

Mr. WESBURY. Thank you, Senator Clinton.

First of all, let me suggest to you that I agree 100 percent with you about the strength of the 1990's. It was a fabulous period in U.S. economic history. In fact, it was the longest economic recovery in our history.

What is interesting, though, is that the period between 1982 and 1990 was the third-longest economic recovery in our history. And when we go back and look at that period from 1982 to 2001, we were in recession during that period only 3 percent of the time. No other 20-year period in our history have we ever experienced uninterrupted growth like we experienced in this 20-year period.

What I would suggest is that we look at what caused that, and in my opinion what clearly caused that was an increase in technology, and the boom in productivity that slowly gained steam over the 1980's and into the 1990's.

I am one of the economists who was out there in the past 5 or 6 years talking about a so-called new era. I realize fully that we still operate under the old economic principles—they are still the same—but what we had done was pushed ourselves back to that kind of growth that we experienced in the Industrial Revolution or in the 1950's or early 1960's.

This does not mean that we cannot have recessions. My belief is that the tax increases of 1993—they increased the number of brackets for taxpayers—and because we had such strong productivity growth, it boosted real incomes, as you pointed out very correctly, and those higher real incomes pushed people into higher and higher tax brackets. There was a tax increase on people throughout the 1990's, and by the time we reached 2000, those burdens reached such a high level that it was finally able to, I believe, topple the economy.

And if I may point out, the bipartisan nature of the tax cut that was passed in May of 2001 at least suggests to me as someone who lives in Chicago that in Washington, people realized that people around the country wanted a tax cut, and that is why we got it, because taxes were too high.

As a result, I think we are now on the way to recovery. My belief is that the best way to guarantee the safety of Social Security, the safety of Medicare, the safety of all the government programs that we have, is to work as hard as we possibly can and have faith in the American entrepreneur. And the way to do that is to increase incentives, and the way you increase incentives is to keep tax rates low and allow the entrepreneur to benefit from his or her efforts.

We live in one of the greatest times in world history, in my opinion. Technology is growing faster than ever before, and that technology is coming from the private sector, and I want to see us support that and allow it to grow. It will make all of our problems, budgetary or otherwise, much less significant in future years if we do that.

Mr. ORSZAG. I have a somewhat different view. I think the key objective in preparing for the longer-term challenges that we face is higher national saving. Basically, higher national saving will leave future workers with more productive equipment, higher levels of productivity, and an easier burden in meeting our future challenges.

In my opinion, the best way to boost national saving is for the Federal Government to have a serious program of fiscal discipline. We have tried lots of other ways to get the private sector to save; they do not work very well. The most auspicious way of boosting national saving is through fiscal discipline.

And I note that in the current environment, changing some of those longer-term fiscal discipline policies would have a short-term benefit. Just like we saw in 1993, when you have backloaded fiscal discipline, you can get short-term benefits from that in addition to the long-term benefits.

So interestingly, normally, there is a tradeoff; right now, I do not think there is one.

Senator CLINTON. Dr. Reischauer, I am going to have to leave, but I know you can be succinct; I have seen it so many times.

Mr. REISCHAUER. And you know I am going to agree with you, too.

Senator CLINTON. And I hate to miss that.

Mr. REISCHAUER. Yes. What Peter said is a necessary but not sufficient answer to the question. We do need an increase in national saving, but we also need structural reform of Medicare and Social Security, and the two can go together.

I just want to make a comment on Mr. Wesbury's view of the 1990's. I am going to have to go back to my VCR and rewind the tape to see what it was really like. This notion that tax burdens rose to oppressive levels and in 2001 were crushing the American people is not supported by the data released by Treasury or CBO, which show, as you pointed out, that for the median family an 150 percent of the median family, tax burdens in fact were lower.

It is true that revenues as a percentage of GDP were close to an all-time high, but there are some very peculiar reasons for that. One of the reasons is that when you have good times, and you have a progressive tax system, that is always true. But there is really more to it than that. This was a period of extraordinary increases in realized capital gains upon which taxes were paid. Realized capital gains do not appear as a component of GDP, so the revenues generated by them are in the numerator, but they are not in the denominator, and if one takes this out, the picture changes somewhat.

It was also a period of extraordinary corporate profits, and we have a system in which, when corporate profits are extraordinarily high, believe it or not, some corporations even pay taxes, and that affects these numbers.

So this notion that the boom came to an end because of oppressive tax burdens, I think is nonsense.

Chairman CONRAD. Let me turn now to Senator Corzine, and I want to thank him for his courtesy to Senator Clinton.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Mr. Wesbury, I will join you in saying that I traded bonds for far too long, and it is reflected in my hairline and my blood pressure, and for some reason, I got the idea as an old bond trader that when the Treasury announced what its financing needs were, it had something to do with what might be certainly the immediate if not long-term direction. And while I accept completely the idea that, other things being equal—and there are a lot of those things going on at the same time—maybe the most important is expectations, what people think is going to happen in the future, like are we going to have sustained periods of budget deficits, do we have this demographic bubble, what is going on with regard to productivity and the size of the economy.

I do think there are plenty of times in history where you could make the case that you tried to make with 1983, 1993, and 2000. When I was a fledgling bond trader in 1976, I think our budget deficits were something like $10 or $15 billion, and rates went from someplace like 6 percent on a nominal basis and about 3 percent real up to that 14 percent. It was quite a ride, and if I think there have been economic studies of that, a lot of that will be attributed first to inflationary expectations at that point in time and second, I think, to growing deficits that were unheard of in the minds of people as they tried to manage those.

But that is an issue that I think needs to be sorted out. There are plenty of examples outside of Japan, and I agree with Dr. Orszag's analysis; I think that real rates are actually very high. They have deflation, if I am not mistaken, going on. But there are plenty of examples where other countries are running large percentages of GDP, where there are high correlations. But I think it is one of those things where the economists need to look at the correlations and over a period of time, other things being equal.

I think that more interesting for today is this percentage of GDP tax issue that has come up before. There is certainly the issue of bracket creep, but capital gains is a substantial reason why we have seen the percentage. I would hope that one of you maybe had at the tip of your tongue how much capital gains were as a percentage of the growth in the percentages of the receipts of the Federal Government that are driving that percentage.

Mr. ORSZAG. I believe Chairman Greenspan actually gave to you a number of roughly a third of the increase between 1995 and 2000 being related to capital gains, either directly through capital gains taxes or indirectly through stock options and other indirect effects, so a substantial percentage. And in 1995, those taxes were only 15 percent of the individual income tax take, so to get a third of the growth out of it shows how paramount that factor was.

Senator CORZINE. I think this is an important issue to learn how to frame in discussion with the American people, because I think we are seeing this percentage of GDP as the justification for tax rate cuts, which I really do not think that that is what it is addressing. One could argue about whether capital gains is an effective stimulator to growth or a depressant, but I think that we need to focus on the reality of what makes up that percentage of GDP.

It certainly felt to me as a participant in the private economy in the 1990's that we had incentives that encouraged people to work and to invest and move forward, and I think it was reflected in the productivity growth that we saw as well as the growth in the size of the economy and therefore the growth in revenues which reduced the deficits.

Let me ask a question that Chairman Conrad focused on, and that is payroll taxes, their regressivity and their linkage, since all money is fungible, to funding other things that we do in our budget.

I think one of the real serious questions I have is how we can take the most regressive aspect of our tax structure and use it to fund deficits. When Mr. Wesbury talked about that we would have been in surplus save the recession in 2002 and 2003, I think we would have been in unified budget surplus, but I do not think we would have been, either with respect to Medicare or with regard to Social Security Trust Fund moneys. I think we would have been using it.

What kind of implications for growth in our economy and for incentives to a large part of the population comes from having a highly regressive flat tax, if you will, imposed on individuals to transfer those moneys into higher income tax brackets do we think we are accomplishing, and isn't it actually a depressant for a large percentage of the overall population?

I would ask any and all of you to respond.

Mr. WESBURY. Shall we go that way?

Mr. ORSZAG. We will start in the middle and go to the end.

Just a couple of things. You are absolutely right—for something like two-thirds of American families, payroll taxes are larger than income taxes. In terms of their effect, though, I would try to separate a couple things. One is the real cost of running on-budget deficits or spending the Social Security surplus is that we are not saving the money. We are not boosting national saving in a way that we could. The distributional implications of that, as Dr. Reischauer noted, really depend on what gets cut ultimately or what else changes to make the whole system balanced. But the immediate effect, the visible manifestation of the cost of running on-budget deficits, is that we are not raising national saving as much as we could if we preserved the Social Security surplus.

In terms of the incentives from the payroll tax, I agree that if you really worry about marginal tax rates, again, for the majority of families, the payroll tax can represent a higher marginal tax increment than the income tax.

I would note that the analysis gets a little bit complicated because effectively, in exchange for paying those payroll taxes, you do get a future benefit in terms of Social Security benefits—and the question then becomes whether workers net out the future benefit that they get from paying the payroll tax, which would attenuate the incentive effects. I think most workers do not do that, but if you are in the hyper-rational" econ man" world, people should be doing that, and that reduces the adverse incentive effect somewhat.

Senator CORZINE. I just find it confusing when we talk about incenting people to work that we have a regressive flat tax that does not change and applies to the vast majority of people and in fact is being used for other purposes to fund other things in the economy and in our government expenditures, some worthy, some maybe not so directly attendant to the needs of the people who are paying it, and we make the case over and over that marginal rate shifts are what is driving the economy, and I am not sure that I agree with that in the context of how well I think the economy did in the 1990's, but I think there is a disconnect between 75 percent or so of the population not really realizing significant marginal rate cuts and using that as a basis for incentives.

I obviously want to hear Mr. Wesbury's comments.

Mr. WESBURY. Well, at least being a proponent of the theory that marginal tax rates do create either incentives of disincentives in the system, a flat tax has no negative incentives for earning more income. So in essence and in fact, the Social Security tax goes away after a certain point of income, and as a result, it is not a disincentive to produce.

I would also argue that taking any of our single, individual tax components out of the whole picture confuses the picture. In other words, we do not have a regressive income tax system, we have a progressive income tax system. It starts out with Social Security and no income taxes and builds until we now have a top rate of 38.6 percent.

At given points on the tax curve, there are bumps where you can actually go from one place to another on taxes—because of the earned income tax credit, you can actually have a higher marginal tax rate to get from one income to the next highest income—but overall, I just disagree that we have a regressive tax system at all. It is progressive—and you have to put all of it together; you cannot just look at one.

Just to go back quickly——

Senator CORZINE. That is in a macro sense, not as it relates to any one individual, isn't it?

Mr. WESBURY. Right, exactly. You are absolutely right. And I am analyzing things from a macro sense.

Senator CORZINE. Since there are more people who fit into one box than fit into the macro box with regard to how it impacts them at a human level, one might wonder how it stimulates the kind of behavior you are talking about on an aggregate basis of the population.

Mr. WESBURY. I guess what I am saying that if we took the payroll tax alone and that were the only tax system that we had, it would be a flat tax, and I think there would be no disincentives to work just from that flat tax, because you are not taxed at higher levels as you move to higher incomes. In fact, eventually, you are taxed at lower levels, so your incentive is to get to as high an income level as you can as quickly as you can, so it actually has positive incentives on work.

Let me address this bond and deficit question and defer to your longer experience than mine in the bond trading world. I would argue that you are 100 percent correct when you say that if the traders sitting on the desk hear that the Treasury is going to issue $15 billion in 10-year Treasury notes next Tuesday afternoon instead of the $10 billion that the market was expecting at the moment of that announcement, interest rates will go up. In the short term, there are impacts on the economy from surprise announcements about the amount of issuance or the size of issuance coming out of the Treasury, no doubt about it.

What I would argue is that over the long term—and I am talking about years—you can find no significant relationship between the level of the deficit or the surplus and interest rates.

You brought up Japan, and let me quickly do the analysis. You are also correct in pointing out that they have deflation. Their 10-year bond yield in Japan is 1.5 percent. They have roughly 2 percentage points of deflation going on right now every year, which means the real interest rate is 3.5 percent.

In the United States, our 10-year Treasury yield is about 5 percent—I think it is 5.12 today. Our inflation rate is about 1.5 percent. Now, this is taking PPI, CPI, all the different measures of inflation, averaging them out, and I get about 1.5 percent. That means that our real interest rate is also exactly equal to Japan's at 3.5 percent.

Now, this is strange to me. If the deficit theory held, excluding deflation—I want to add one other thing, and that is that Japan is in deep trouble today. We are seeing banks downgraded by Moody's and other analysts in the economy. In fact, you should see real interest rates rising in Japan as the risk of investing in Japan rises. And what we are seeing today is that despite their huge deficits and the risks of investing in Japan, their real rates are at exactly the same level as ours despite their massive debt as a share of GDP—130 percent versus our 34 percent.

So again, while I believe you are 100 percent correct about the shorter-term moves in interest rates, in the long term and between various countries, I find no relationship between debt and interest rates at all.

Senator CORZINE. Well, there are interest rate parity theorems that allow for exchange rate depreciation and appreciation to match all those kinds of things. I think that most economists would argue that in the long run, real interest rates would match up in some form as you go through the adjustment process.

I actually think that the case that those of us who think long-term rates are higher than we would have thought they would be is exactly an expectation argument. It is an expectation of looking at the demographics which everybody knows are real and are going to put enormous pressure on Social Security and Medicare costs in the next decade and the end of these tax provisions that no one knows how it is going to get adjusted unless they are going to be renewed, which is the likely case, and if that is the case, then, we go back to Dr. Orszag's case—we are going to have over the next 75 years more money in tax cuts than we are going to have for the money available for Social Security that we need to have.

So I think the market is factoring those in. I think that is why we have those rates relative to where they would have been otherwise given what the Federal Reserve has done.

I have taken too much time, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Corzine.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

I apologize for coming in late. We have a Banking Committee hearing going on just one floor down, which my colleague Senator Corzine is also a member of, so we trade back and forth on money-laundering. It is at moments like this that cloning actually looks appealing. [Laughter.]

In have one question for the panelists but if I might just comment in general on all of the discussion, I find it interesting that we do not look at our own recent history in the last two decades and really look at the difference in what we are talking about today. To me, there is a very clear analogy between what happened in the eighties and what happened in the nineties. What I see now happening is a return to what happened in the eighties which, frankly, Mr. Chairman, was not very good for my State of Michigan or the country. So I would just observe that in the eighties there was the kind of approach that is used now, focusing on supply side economics, trickledown theory, which some folks in Michigan are still waiting to trickledown, and massive buildup in defense. And while I certainly support the efforts to focus on security and safety for the country, we have that analogy happening and tripling the national debt—tripling the national debt—and interest rates skyrocketed.

Int he nineties, we saw an attempt to begin to get a handle on balancing the budget. We actually interesting saw in 1993 a tax increase on the top 1 percent, a tax cut by earned income tax credit and expanding that to low and middle-income taxpayers, an effort to focus on paying down the debt, balancing the budget; interest rates came down, economic activity grew, and we had a wonderful explosion of economic activity, and in fact we were able to balance the budget in 1997 for the first time in 30 years, which I was pleased to be in the House to participate in.

So in my mind, we have two different approaches—one that focuses more on fiscal responsibility, paying down the debt, more of a demand side approach to tax cuts on the one hand; and on the other hand, a supply side economics approach that disregarded the national debt—in fact tripled it—and also did not rein in spending. And as the Chairman has said numerous times, despite the rhetoric, the reality is that as a share of GDP, spending has gone down, and the efforts in the nineties to focus on restraining spending I think did make a difference.

So I would just say that I am not an economist, but I do look, at least in my lifetime, at differences, and if the eighties had worked, I would be here advocating that we do it again. I did not see it work, at least not for Michigan, and certainly the people of Michigan do not want to go through the eighties again.

That is why I come to where I am, and I will now ask my question. And this is not a new question, and the Chairman is probably tired of hearing me talk about triggers, but I do want to ask you if in fact we ought to have some return to fiscal responsibility and a balancing of the efforts to both restrain spending as well as issues of not returning to massive debt, which right now, we are headed in that direction. I would like the panelists' comments about the framework of putting together an economic trigger that first of all would not even come in as a factor until 2004, with the next step of the proposed decrease in the tax cut, but would give us a framework for looking to the future in terms of the potential massive buildup of that and the use of dollars that have been put aside for Social Security and Medicare, and in my mind, the effort that is coming which, while there is no relationship to Enron, I believe the analogy is correct of saying that if we continue on this track, we are saying that those at the very top, the top one or 2 percent of the public, ought to be able to get their money out in their pockets, and it will be paid for on the backs of the retirement system of the majority of Americans, which in this case is Social Security and Medicare, which I have deep, deep concerns about.

I would welcome your thoughts about triggers.

Mr. REISCHAUER. Senator, while I was listening to you compare the 1980's and the 1990's—and I certainly agree with your conclusion, I was struck by how you said that if the 1980's had worked, you would be here defending the 1980's. I was thinking to myself you probably would not be here if the 1980's had worked, for political reasons.

Let me comment on your question about triggers. I think they are a second best. I think the best thing you can do is to ask how much of the tax cut that was enacted in June of last year, can we afford permanently now, knowing what we know now about the likely future of the economy and the other demands and needs of the Nation. As I suggested in my testimony, I think that would lead to a conclusion that we should freeze the tax cut at where it is now—I mean, the elements that have been implemented—and index those.

To go to a trigger which would say that if certain conditions prevail, we will allow the next tranche of the tax cut to go into effect, introduces first of all a degree of uncertainty into the future and the possibility for gimmicking. It will be very difficult for whoever has his or her finger on the trigger to pull the trigger, particularly if it is a point at which an election is coming up, and the outcome of the election is somewhat in doubt. So I think you are better off, really, biting the bullet now as opposed to kicking the ball down the road, which so often is the easier political route to go.

Mr. ORSZAG. I agree with what Dr. Reischauer just said. I would just add that one of the proposals that we have put forward is a sort of minimum, that after the Congress passed the tax legislation last year, there was a pot of money that was supposed to be left over outside of Social Security and Medicare, and at a minimum, one could argue that the rest of the tax bill should not go into effect until, after those future provisions come into effect, you leave the same amount of money.

The Congress went through a variety of changes, including the sunset in 2010, in order to fit the tax legislation into a certain cost estimate in order to leave that residual or that insurance policy. That is now gone, and until that layer is back, the rest of the tax cut should not go into effect. That would be a minimum, and I think more is required, but there seems to me at least to be a certain logic to that.

Senator STABENOW. I would just comment that that really is one form a trigger, to put in place a certain——

Mr. ORSZAG. That is one form a trigger, yes.

Senator STABENOW [continuing]. A certain surplus or debt reduction number or whatever, and then be able to make sure that in fact we have that insurance policy before we proceed with anything further.

Mr. ORSZAG. That is correct. And if I could just add very briefly, Mr. Chairman, in the spirit of interplay between the witnesses, I just want to note two things. First, I am not going to buy into the simple comparison between the United States and Japan on real interest rates, but I think it is highly unlikely that U.S. inflation rates over the next 10 years are expected to be 1.5 percent. If you look at the CBO numbers and any other private forecasters', over the next 10 years, you are looking at about 2.5 percent, which then means that real interest rates in Japan under this comparison, which again I am somewhat reluctant to enter into, would be higher. And I guess I would be willing to put my money where my mouth is, and if Mr. Wesbury wants to take a bet on whether inflation will be 1.5 percent over the next 10 years, I would be willing to do that.

I would also just note on the Social Security tax that only 6 percent of workers exceed the Social Security payroll maximum. So for 94 percent of workers, they are facing that marginal tax rate. It is true that when you go over the cap, your marginal tax rate falls, but the vast majority of workers never get there.

Thank you for indulging me on those two points.

Chairman CONRAD. Do you have other questions?

Senator STABENOW. I do not know if Mr. Wesbury would like to respond; and then I have no further questions.

Mr. WESBURY. I do have a brief response.

Chairman CONRAD. Absolutely. Mr. Wesbury, go ahead.

Mr. WESBURY. Thank you, Mr. Chairman.

Senator I have two brief comments. Your recollection of the eighties in my opinion does not fit with the data. Between 1982 and 1987, when we had huge deficits, the economy grew on average 4.4 percent per year. Between 1995 and 2000, when the economy went from deficit to surplus, the economy grew 4.1 percent per year—actually less than it did in the mid-1980's.

Senator STABENOW. Let me ask two questions. Did we in fact triple the national debt in the eighties?

Mr. WESBURY. Yes.

Senator STABENOW. Were interest rates higher in the eighties or in the nineties?

Mr. WESBURY. On average—on average—they were higher in the 1980's, but they came down significantly in the 1980's, from 15, 16, 18 percent down to, when they exited the 1980's, 7 or 8 percent. They came down much more in the 1980's than they did in the 1990's.

But one of the interesting things—and this is what you have to ask yourself—companies, people, borrow money all the time. We do into debt. I am sure you have some debt in your life. I have debt in my life. My company has debt to help it operate on a daily basis. And the reason why we go into that debt is because it promises something better in the future. And during the 1980's when we tripled the national debt—and I am not quite sure of the exact ratio, but I will buy the tripling—it went up by about $3 trillion, and our economies assets—total assets—housing stock, stock market, bond stock—all the assets in the economy went up $10 trillion.

So in other words, we borrowed $3 billion to create $10 billion. That is a great tradeoff, and I do not know of a bank in the world that would not lend the money to a company that was able and promised to do that. The United States economy actually had a fabulous 1980's. I am from Illinois—we are not that much different from Michigan—and I think the unemployment rate came down, the inflation rate came down, interest rates came down, and growth picked up.

So I just do not see what you see in the 1980's versus the 1990's.

Senator STABENOW. If I might comment, Mr. Chairman, and then turn it back to you—first of all, I would be happy to share with you what happened in Michigan in the 1980's. I do not know about Illinois, but I was in State government in the 1980's and saw what we had to go through and what happened with unemployment, and I can assure you that if I were to ask people in my State if they would prefer the 1980's or the 1990's in terms of how it affected their family, their jobs, and so on, they would not pick the 1980's.

But the other thing I would say on your analogy is that we all go into debt. I have a mortgage, I have a car payment, I have credit cards—most Americans do that. But we also know when we go into debt too far. If I am so in debt—if I have every credit card at the maximum, and I have a mortgage and two car payments and so on—and then, my mother needs to go into a nursing home and needs my help, I am going to be hard-pressed to be able to help her at that point, because I have leveraged myself so much and at that point may then have to go into much further, more extravagant debt that risks my family.

That is what has happened here. We are placing ourselves in a situation where we are leveraging and potentially creating so much debt that when those of us who are baby boomers start bringing the bill due for Social Security and Medicare, we will jeopardize the future for our children by placing ourselves in a situation of having to go into massive debt or make other kinds of decisions that are not good for our families.

So that is my objection to where we are going. Some debt is fine, but overextending the country, just as if I overextended my own family, would not be wise, and we would be held accountable, and I am fearful that in fact we will be held accountable.

Thank you, Mr. Chairman.

Chairman CONRAD. Dr. Reischauer signalled me that he would like to address something that came up.

Dr. REISCHAUER. I would just like to comment on the discussion of Mr. Wesbury about the 1980's and the 1990's. We should not confound cyclical growth with the potential growth of the economy, the long run potential growth.

Mr. Wesbury compared growth between 1982 and 1989, which was a period that started at the depth of the second-deepest recession, or the deepest recession of the post-war period when we had an unemployment rate of over 10 percent with what happened during the 1990's. I think the proper comparison is to look at underlying rates of productivity growth in the two decades. There, you will find that there was a significant difference, particularly in the last half of the 1990's we had, for reasons that we do not fully understand, and I am in agreement with Mr. Wesbury about the important role of technology that has a long period of gestation, and the importance of low tax rates as well. But we did for reasons, some of which remain inexplicable, some of which we would like to attribute to the turnaround in fiscal policy during the 1990's, enter into a period in which productivity growth seemed to be higher than it had been at any time from the early 1970's through the early 1990's. So from that standpoint, which I think is the important measure, the 1990's were really an improvement over the 1980's.

Chairman CONRAD. I thank Senator Stabenow.

I think every committee of the Senate is meeting today because functionally, we will not be having committee meetings for the rest of this week; so that is part of what is happening here.

I would like to continue this discussion for an extended period, because I think we are on what is a really critical issue going forward, and we have three of the best witnesses that I have heard in tandem on this subject. I really think all of you are excellent witnesses.

Let me ask you this. We are in agreement that economic growth is really the key to meeting our obligations in the future for Medicare and Social Security. The question that will be before a future Congress is the size of the economy at that time and the ability to meet the obligations that have been generated.

Alan Greenspan was very interesting on this subject last week, saying that he looks at not just the publicly held debt, he looks at the debt that is considered a contingent liability, some $10 trillion. It is considered contingent because the theory is that Congress could change the promise made in Medicare and Social Security at any time. That is really not realistic in his view, the notion that Congress could somehow change the fundamental promise that has been made. I think he is right, and on that basis, this contingent liability of $10 trillion, the vast majority of it, he told me he thought that probably 95 percent of it or more, is a true liability, not contingent at all.

So that is a reason he believes it is important to go back to running surpluses as we define them. We call them surpluses here. I do not really consider them surpluses; I consider them funds necessary to meet promises that have already been made.

But if we are agreed that the size of the economy at the time that those liabilities come due is truly the key issue—and I think we are basically agreed on that; if anybody disagrees, please say so—what would be your prescription for fiscal policy going forward? What do you think should be the outline of the fiscal policy going forward?

Dr. Reischauer, you raised your hand first. Go ahead.

Dr. REISCHAUER. This is on the issue of whether I think that whether the economy is 30 percent larger than it otherwise would be in 2030 really makes a difference for these liabilities. I guess my answer to that is that if that 30 percent larger GDP is already committed to tax cuts, to program spending, to other things, politically, it will be just as difficult to transfer resources to the elderly as it would be if you had a smaller GDP, because people will be used to those lower tax rates or those higher spending levels and will regard it as a negative change.

So what you want to do is build in some kind of fiscal margin and segregate the resources, either privately or through some government collective investment in private assets, which then can be drawn down for these purposes. But that really involves structural reform of these two programs.

Chairman CONRAD. You are talking about really treating trust fund moneys as if they were a trust fund.

Dr. REISCHAUER. Basically, yes.

Chairman CONRAD. Dr. Orszag?

Dr. ORSZAG. First, let me just say that while I think, as Dr. Reischauer noted, that the size of the economy is a critical component of the affordability of our future liabilities, it also matters how we spend that output. So having more output is great, but we also need to worry about how it is distributed to different purposes.

I would also just note that while the figures that are being discussed are correct based on current expectations, these longer term projections, both for the contingent liability under Social Security and also the so-called fiscal gap, are very sensitive to the assumptions that are plugged into them. But that does not mean that we do not have a problem. It just means that we should be a little bit wary about the precise numbers; they can move around.

On Social Security reform, as we have discussed before, my view is that the tax cut has impeded Social Security reform regardless of whether we have individual accounts or not; that we need some funds outside of Social Security to grease the wheels of the reform and get us on a more sustainable path; that without those funds, there is too much "broccoli" in the reform plan, and it will not get done, and for a period of time, you need money from outside Social Security to grease the wheels of the reform.

So that in a sense, unfortunately, if the full tax cut does take effect, the longer-term legacy, in my opinion, may be that if impeded Social Security reform.

Chairman CONRAD. Let me just say that the broccoli people are calling now and are very unhappy with the negative reference. [Laughter.]

Mr. Wesbury.

Mr. WESBURY. As you mentioned in your introduction of me, I was here in 1995–1996 with the Joint Economic Committee, and I do not remember using "broccoli" in any of our—so that must be new.

I will suggest that I am not an expert on the Social Security Trust Fund, and what I came to talk about was the interrelationship between the budget and the economy. In that regard, what I would suggest is that with all liabilities in the future, the key—and I am reiterating what I said earlier—is the growth rate of the economy.

In fact, because of the boom in growth in the late 1990's, we were actually seeing some estimates that problems with the trust funds were being pushed out by a couple of years. This was up about a year ago. Obviously, things have now changed a little bit. And I would argue that that shows us the power of growth; that if we can sustain 4 percent real growth or higher in the future, a lot of these problems and these liabilities will be taken care of.

One statement about that. I do believe that giving individual ownership of private accounts a try is actually a good policy, and I hope we discuss that more in the future. By allowing individual ownership, we create all kinds of different incentives in the system, and we can actually lower that liability whether it is contingent or not as we move into the future.

One last point, and that is that—I am blanking on my last point, so I will just stop there.

Chairman CONRAD. While you are thinking about it, let me just say this to you. I think Dr. Reischauer is wise to caution us that it is the case that economic growth has a bearing on our ability to meet these liabilities in the future. The political realities at the time are also critically important, and what the experience of people has been with respect to tax levels, with respect to benefit levels, with respect to other spending that the Federal Government is doing, whether on defense or homeland security or whatever the priorities are that are experienced at the time, will have an effect on the ability to meet those obligations and the perceived difficulty and sacrifice necessary to meet those obligations. I think that is the point that I heard you making, Dr. Reischauer.

To me, there were tragedies in what was done last year on taxes. I was strongly in support of a tax cut last year; I proposed one which I thought was significant, $750 billion over 10 years not counting the interest cost—with the interest cost, it would be about $900 billion. The President proposed $1.6 trillion not counting the interest cost—with the interest cost, that would be about $1.9 trillion.

The difference was that I took the difference between those two, and I set the money aside so that you could establish private accounts in Social Security. In other words, I provided the money for the transition; whether they were add-on accounts or as part of an overall picture, I set aside the resources to do it. That was the first casualty of the process last year, and I think people will look back at some point and say that was a missed opportunity, and it is going to be hard to get back in a position to be able to do that—very hard. The President has said over his dead body to even any deferral of the future tax cuts. And you look at these numbers that CBO has come with, and frankly, in many ways they are optimistic because they do not contain things that we all know are going to happen. The President is going to ask for a substantial buildup in national defense, as he should—whether the exact number he is coming with is the appropriate number, I do not know; we have not gone through that yet—but he is going to get a substantial increase in national defense; is there anybody who doubts that? I do not think so.

He is going to get a substantial increase in homeland security, and he should. I do not think there is any doubt about that.

We are going to extend the tax provisions of the current code. That is not in these estimates. It is going to happen—we all know it—and it should happen—not every one of them; I think there are some of them that ought to be tossed out—but we know that most of them if not all of them are going to be approved.

We know that a new farm bill is going to be passed. We know that some of these other matters are going to have to be dealt with. The alternative minimum tax on individuals—now they tell me that just to fix the impact of the last tax bill on individual alternative minimum tax is going to cost $300 billion. Does anybody believe that we are really going to let tens of millions of people be caught up in the alternative minimum tax over the next decade? I do not think so.

Where is the money coming from for all of these things?

I guess I have never been more frustrated than when watching the news accounts of what is happening, because it is as if we are just kind of divorced from reality. I grew up in the Midwest. I grew up in North Dakota. I grew up learning that debt can be positive and that debt can have a vicious negative side to it.

I remember my grandfather, who owned stock in the local bank, in the days of unlimited liability—when you owned stock, you were not limited by the liability of your investment—so when things turned sour in the 1930's—and in North Dakota, they turned very sour—the banker would call up my grandfather and say, "Bring down some more money"—and it happened week after week after week. The banker would call up and say, "Bring down some more money."

And families all across our State were ruined. It took my grandfather a decade to recover. They did not believe in going bankrupt in those days. They did not do it.

So debt can work both ways. Debt can be very positive in terms of enabling a company or a government to do things that would not otherwise be done. It can also, when it grows too much, reach a tip point and create enormous hardship. And I guess that is one reason why I am so focused on this question and very concerned about what I see as the direction of a country that for the moment just seems divorced from the reality of our obligations versus what we are willing to do to tax ourselves to meet those obligations. And there is now a big chasm here—a big chasm. And it is not just this year. I would be much less concerned if it were a one- or 2-year matter. This is not a one- or 2-year matter. We are talking about the next decade, trust fund deficits of enormous proportions.

With that, we are just at the end of a vote on the floor, and I have got to go, but I do not want to leave here without again thanking each and every one of you. You have been really excellent witnesses, and I appreciate very much your time.

The committee is adjourned.

[Whereupon, at 11:47 a.m., the committee was adjourned.]

PROPOSED FISCAL YEAR 2003 BUDGET

TUESDAY, FEBRUARY 5, 2002

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

The committee met, pursuant to notice, at 10:06 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad (chairman of the committee) presiding.

Present: Senators Conrad, Hollings, Murray, Feingold, Johnson, Nelson, Stabenow, Clinton, Corzine, Domenici, Gregg, Snowe, Frist, and Smith.

Staff present: Mary Ann Naylor, staff director; Chad Stone, chief economist and Jim Horney, deputy staff director.

For the minority: G. William Hoagland, staff director; Cheri Reidy, senior analyst and Bob Stein, chief economist.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The Budget Committee will come to order.

We welcome Director Daniels to the committee to discuss the President's submission for the year.

I am going to start out with a statement and then turn to my ranking member for statement, and then we will go to the director for his testimony. Then, as is our tradition, we will reserve 7 minutes for statements and questioning by each of the members, in order of appearance; as is our typical rule here on the Budget Committee, we follow the early bird rule.

First of all, let us acknowledge that this is a dramatic change of circumstance from what we faced last year. Part of that is due to the war; part of that is due to economic downturn; part of that is also due to the tax cuts that were enacted last year.

The President in his State of the Union message said: "Our budget will run a deficit that will be small and short-term." If true, that would be understandable given the war and the recession. But let me put up what USA Today wrote in an editorial yesterday about that statement by the President.

14A · MONDAY, FEBRUARY 4, 2002 · USA TODAY

Today's debate: National debt

Budget takes ugly turn: Deficits for years to come

Our view:

By spending Social Security surplus, Bush hides depth of deficit.

Today, President Bush puts the meat on his promise of a budget that, for the first time in four years, shows red ink at the bottom line.

As he noted in his State of the Union address last week, deficits are needed for now to fight the war on terrorism, protect the homeland and boost the economy. But, Bush promised, the return to deficit spending will be "small and short-term."

Don't believe that for a moment. Even before the official numbers are released, one thing is clear: The deficits will be big and will last for nearly a decade. Only by resorting to accounting gimmicks that would make Enron blush can Bush claim otherwise.

According to the non-partisan Congressional Budget Office, which released its budget projections in late January, the deficit next year will be close to $200 billion; the government won't see another surplus until 2010. By 2012, the government still will be carrying $1.3 trillion in debt.

And that's before counting any of the new and expensive spending programs the administration has already said it plans to offer, or what Congress surely will add. Among the items on Bush's wish list for next year:

► A $45-billion hike in defense spending, the biggest increase in two decades.

► A $90-billion economic-stimulus package.

► A record $27.3 billion for the National Institutes of Health, an increase of nearly 16%.

Then there's the laundry list of new tax credits for health insurance, an expanded national service program, more money for veterans' health and a Medicare prescription-drug benefit. Overall, Bush plans to hike spending by about 9%.

To make the deficits look smaller, Bush has included the $178-billion surplus that Social Security will run next year, and the nearly $1 trillion it will amass during the following nine years.

That is good short-term politics, making it seem as though all of this extra spending, on top of the oversized tax cut enacted last year, costs the nation's fiscal future little.

But in the long term, it amounts to a disastrous shift away from protecting the nation's financial security.

Remember that right up until Sept. 11, Bush and just about everyone else in Washington were pledging to keep Social Security surpluses off-limits to tax cutters and spendthrifts. And for good reason.

Left unspent, the surpluses go toward paying down the federal government's gargantuan debt. That would help cut interest rates, boost economic growth and free up money to reform Social Security and Medicare before baby boomers start retiring.

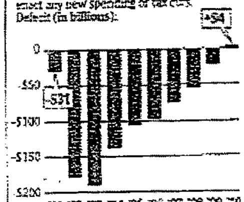
The focus on preserving Social Security surpluses also had a less obvious, but critically important, benefit. It acted as a powerful break on would-be tax cutters and big spenders. Anybody who wanted to propose a break or create a program had to do so without using the Social Security surplus.

With that regulator gone, the spending machine will almost certainly careen out of control. Producing a surplus, real or fictional, will be even more difficult.

Bush is right that the middle of a recession is no time to raise taxes or cut spending to hit a surplus goal. But with the recession showing signs of abating, he needs to tell the public how he plans to get the nation back on track to paying off the debt.

Deficit likely to linger

Without using Social Security surpluses to mask it, the deficit looms large and stays long. And that's assuming Congress doesn't enact any new spending or tax cuts.
Deficit (in billions):



Source: Congressional Budget Office

By Keith Simmons, USA TODAY

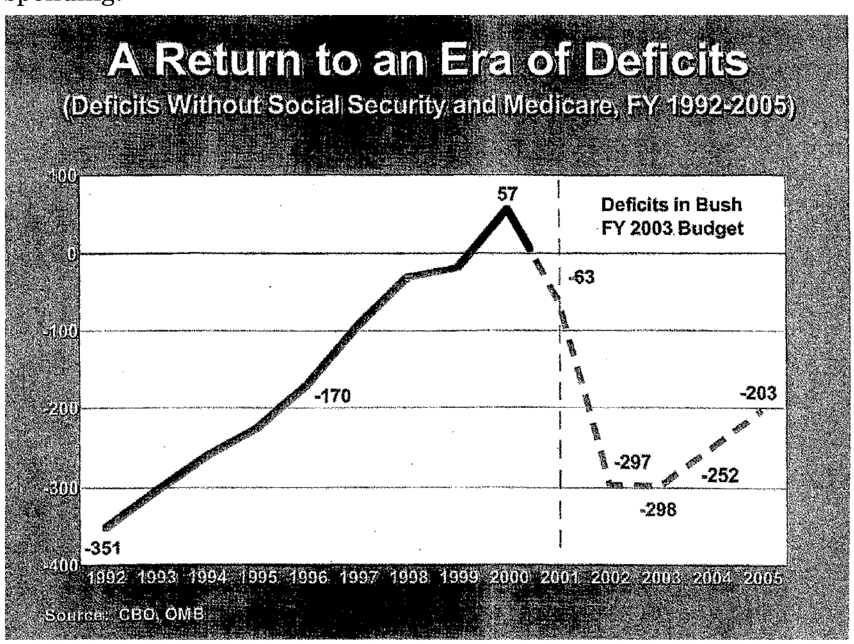
They said of the return to deficit spending that the President claimed would be small and short-term—their response was: "Don't believe that for a moment. Even before the official numbers are released, one thing is clear—the deficits will be big and last for nearly a decade. Only by resorting to accounting gimmicks that would make Enron blush can Bush claim otherwise."

They go on to report that "To make the deficits look smaller, Bush has included a $178 billion Social Security surplus next year, and the nearly $1 trillion of Social Security surpluses during the following 9 years. They say that is good short-term politics, making it seem as though all of this extra spending, on top of the oversize tax cut enacted last year, cost the Nation's fiscal future little."

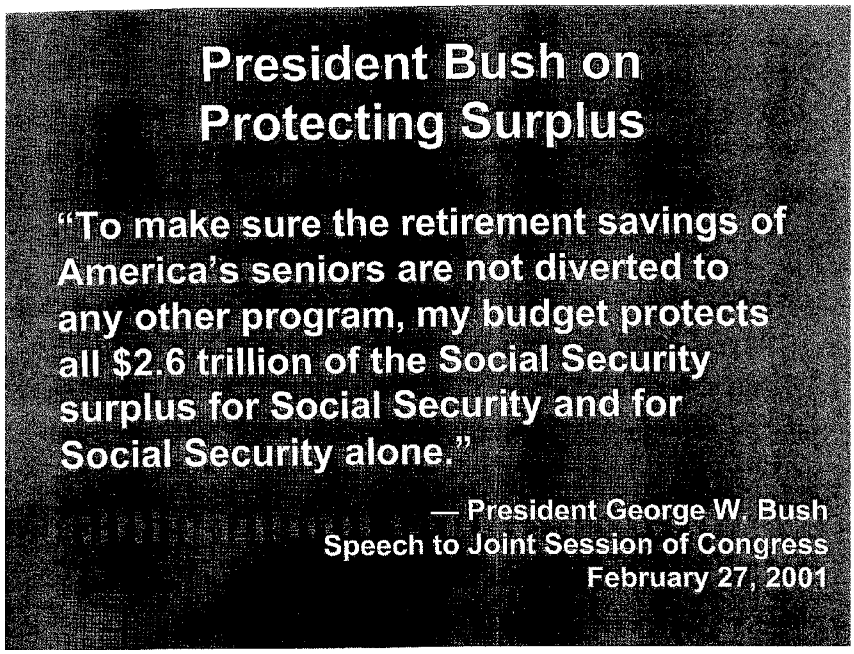
But they say that "In the long term, it amounts to a disastrous shift away from protecting the Nation's fiscal and financial security."

They conclude by saying: "Remember that right up until September 11, Bush and just about everyone else in Washington were pledging to keep Social Security surpluses off-limits to tax-cutters and spendthrifts, and for good reason. Left unspent, these surpluses go toward paying down the Federal Government's debt. That would help cut interest rates, boost economic growth, and free up money to reform Social Security and Medicare."

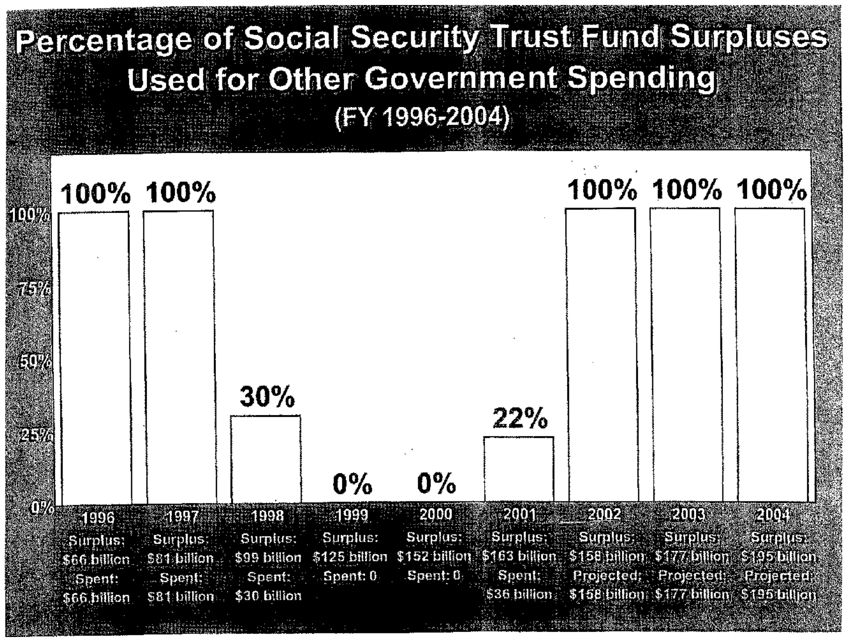
What they are talking about is what we see. We do not see deficits as the President asserted, being short-term and small. What we see is an ocean of red ink. What we see is deficits right through the decade. What we see is the use of Social Security and Medicare Trust Fund money by over $2 trillion to fund tax cuts and other spending.



Let me just put up what the President said last year with respect to protecting the surplus. The President said: "To make sure the retirement savings of America's seniors are not diverted to any other program, my budget protects all $2.6 trillion of the Social Security surplus for Social Security and for Social Security alone."

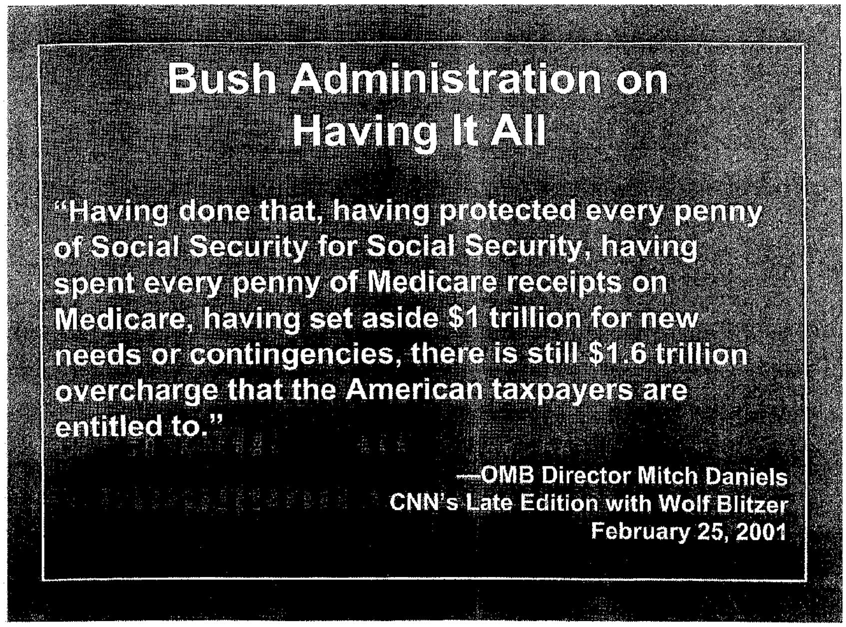


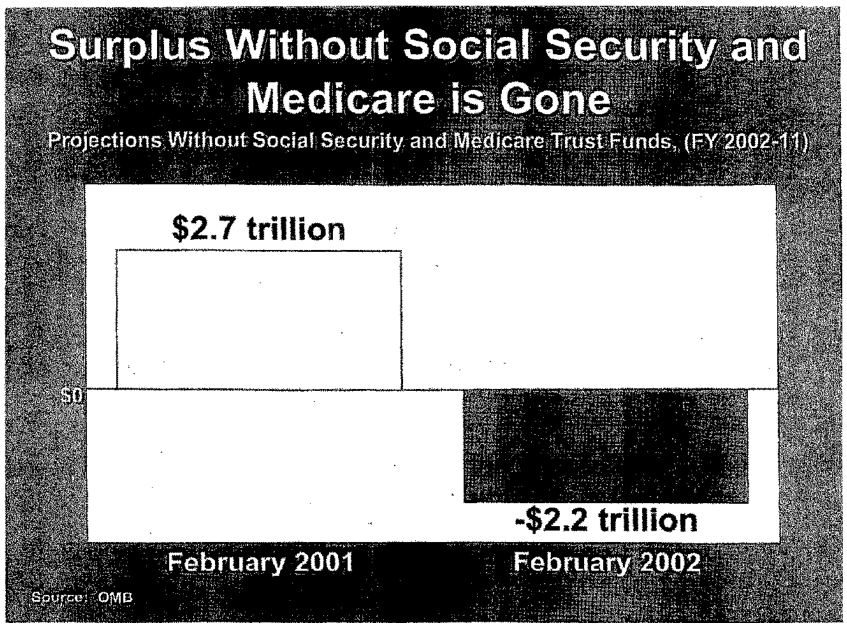
Now we see that that statement was in error. If we look at the next chart, which shows the percentage of Social Security Trust Fund surpluses being used for other Government spending, we see that in the bad, old days, we were using Social Security Trust Fund money for other purposes. That was dramatically reduced in the 1998 budget. We stopped using Social Security Trust Fund money for other purposes in both 1999 and 2000. In 2001, we started going back the other way, and under the President's plan, in 2002, 2003, and 2004, 100 percent of the Social Security surplus is being used for other purposes.



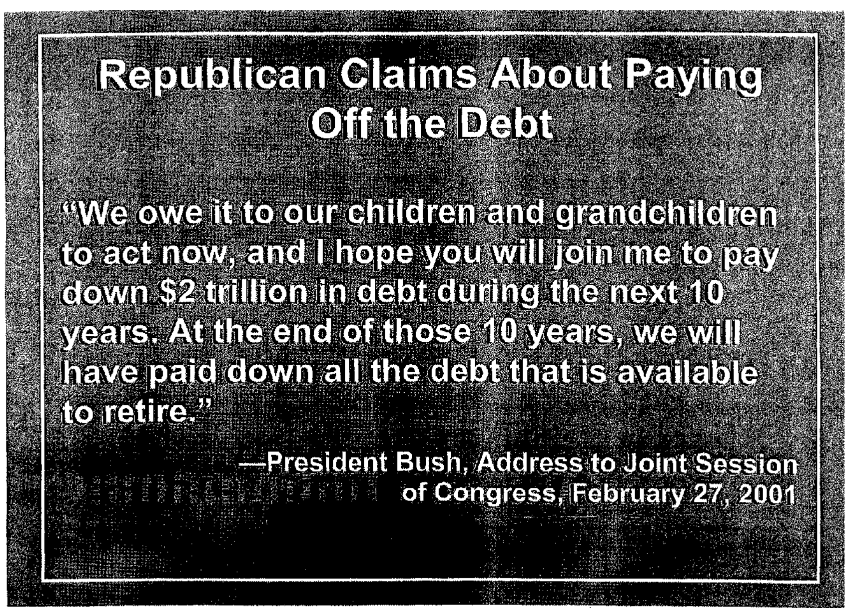
Last year, Director Daniels, you said in a news broadcast on Late Edition that "having protected and set aside money for the needs of the country, having protected every penny of Social Security for Social Security, having spent every penny of Medicare receipts on Medicare, having set aside $1 trillion for new needs or contingencies, there is still $1.6 trillion that the taxpayers are entitled to."

Well, again, what we see in light of this new budget is that you have not protected Social Security or Medicare. Instead what this budget reveals is that you are taking $2.2 trillion of Social Security and Medicare surpluses and using them to pay for tax cuts and other expenditures—something the President pledged not to do.

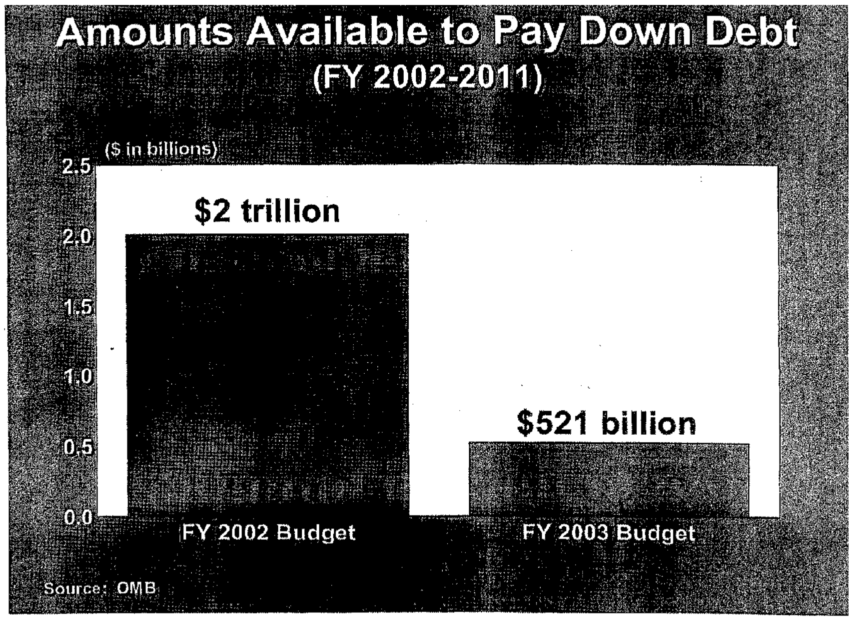

Bush Administration on
Having It All
"Having done that, having protected every penny of Social Security for Social Security, having spent every penny of Medicare receipts on Medicare, having set aside $1 trillion for new needs or contingencies, there is still $1.6 trillion overcharge that the American taxpayers are entitled to."
—OMB Director Mitch Daniels
CNN's Late Edition with Wolf Blitzer
February 25, 2001



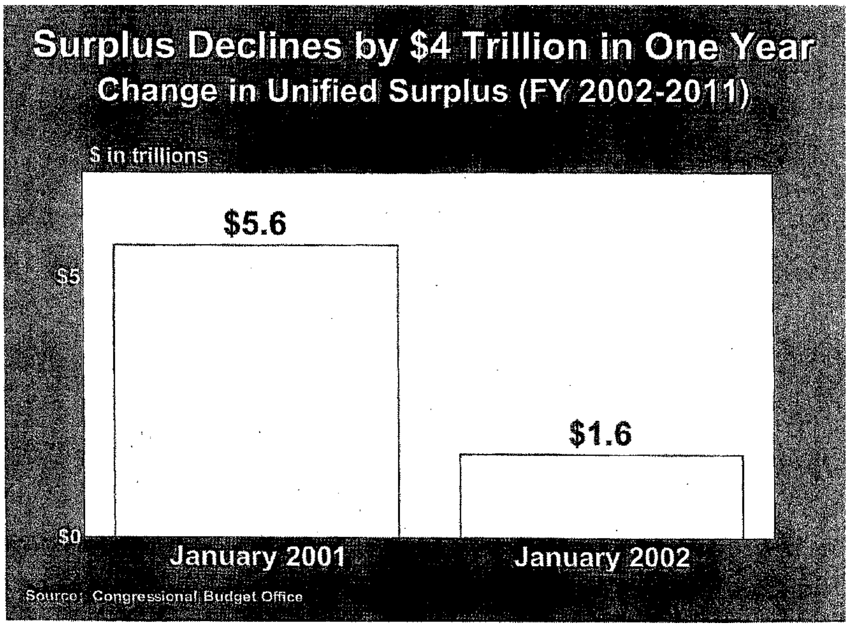
There was also the assertion of last year that you would be paying down the maximum amount of national debt. The President said in his address to the Joint Session last year: "We owe it to our children and grandchildren to act now, and I hope you will join me to pay down $2 trillion in debt during the next 10 years."



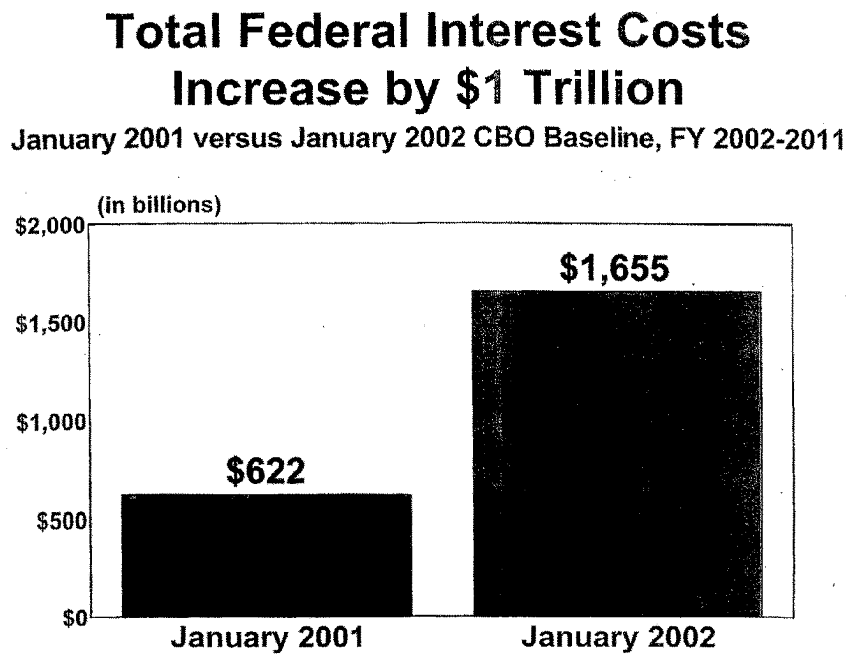
Again, we see that that statement was inaccurate; that instead of paying down $2 trillion of debt during this period, the President's budget this year shows we will be paying down just over $500 billion of the debt.



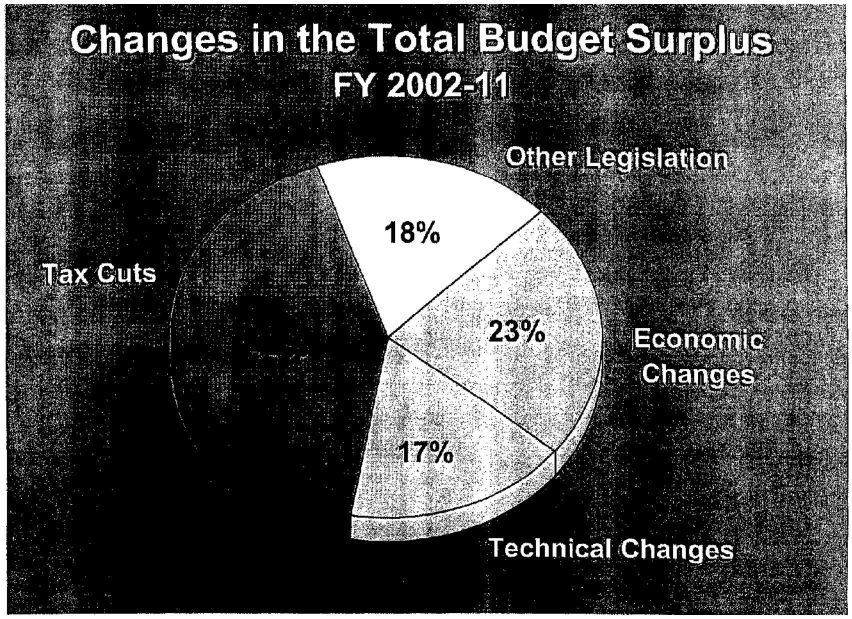
The result is that total Federal interest costs go up by over $1 trillion, this according to the Congressional Budget Office. Instead of paying $600 billion of interest over the next decade, we will be paying over $1.6 trillion in interest.



When Director Crippen of the Congressional Budget Office came here to testify, he indicated that the surpluses which last year were projected at $5.6 trillion had been reduced to $1.6 trillion. And when we looked at the reasons, according to CBO testimony, what we found, despite the indications from the Administration that this was all related to the war and the economic downturn, was that in fact the biggest factor was the tax cut that the President proposed and pushed through Congress last year. Over the 10 years, 42 percent of the decline in the surplus was as a result of the tax cut; 23 percent, the recession; 18 percent, spending largely caused by the attack on this country on September 11; 17 percent, technical changes.

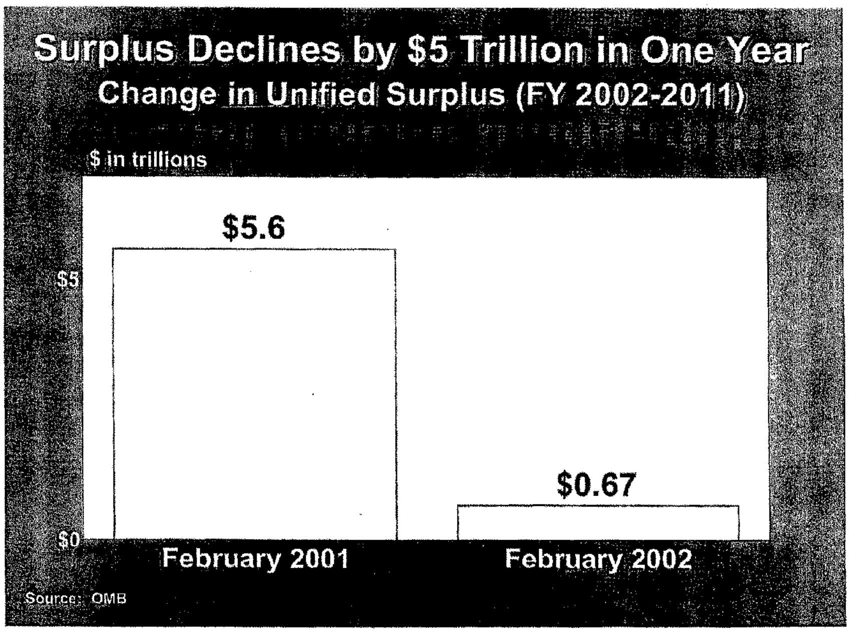


All of this tells me that the prudent person putting a budget out this year would decide not to dig the hole any deeper. But what we see in the President's budget is to keep digging the hole deeper and deeper, taking more Social Security Trust Fund money to use for other purposes, taking all of the Medicare Trust Fund money to use for other purposes. In fact, instead of $5.6 trillion over the period of 2002 to 2011, the President's budget leaves something over $600 billion.



I believe the truth is there are no surpluses because all of that money is fully committed. In fact, it is overcommitted. In fact, as Chairman Greenspan told us, these so-called contingent liabilities of the Federal Government are not contingent at all. We owe that money, and we are going to have to pay it. And to fail to acknowledge it puts this country in much the same position as Enron—not acknowledging the true debt that we face.

So what does it all mean? Director Crippen when he was here concluded his testimony by saying: "Put more starkly, Mr. Chairman, the extremes of what will be required to address our retirement are these. We will have to increase borrowing by very large, likely unsustainable, amounts; raise taxes to 30 percent of gross domestic product"—we are at about 19 percent now—"obviously unprecedented in our history; or eliminate most of the rest of government as we know it. That is the dilemma that faces us in the long run, Mr. Chairman, and these next 10 years will only be the beginning."



I believe Director Crippen is telling it straight, and I believe the President's budget fails to address the long-term fiscal imbalances facing the country and as a result puts our financial security in jeopardy.

I turn now to my ranking member, Senator Domenici, for his statement.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Thank you very much.

It is not often that we get the OMB Director here before us and that we have a whole morning, more or less, to inquire of him. I hope the members on our side, speaking just to them, will avail themselves of an opportunity to come down and get some of their thoughts on the record and get some of their questions asked.

First, I might say to my good friend the Chairman that we have plenty of time—you have plenty of time. If, as a matter of fact, there is something wrong with this budget that ought to be corrected because it is perilous, as you have described it, you know that you are going to have plenty of time to fix it; and if you have a better way, I anxiously wait to see what it is.

And at the end of my remarks, I was going to say—but I will say it now—that I look forward to working with you in an effort to put together a bipartisan budget if that can be done. You cannot count on me for just any, old budget that you would like to put together, but obviously, if you think you have a way of doing it better than the President, I stand first on the side, watching, and as you proceed with it, I will become involved to the extent that it may, as you suggest, make better sense for America than the budget we have here.

However, I do not intend to hold my breath until that event, because I think that is going to be very difficult to do. I think we are going to have to decide that some of the basic concepts that the President of the United States has laid before us must be addressed and must be faced.

Yesterday, we received the President's budget for 2003, and this budget shows that this President says what he means, he means what he says, and he does what he promises.

When I met with the President a few weeks ago in the company of the House Budget Committee chairman—it was about 2 weeks and a little bit ago—I said then and I say again that this budget is about setting priorities. Some might want it to be an exercise in dreaming, an exercise in coming up with ideas that sound good and that may indeed make people focus on something that is not the reality of this particular fiscal situation in which we find ourselves.

President Bush's $2.1 trillion wartime budget sets as its first priority security of homeland, fundamental to our constitutional government. Without this security, as outlined by our Founding Fathers, democratic government as we know it cannot exist. The second priority is the further strengthening of our military, both intelligence and the military in general, to be ready to destroy those who threaten our government.

The third priority is to restore health to the economy and provide the security of a paycheck to those who have been unemployed.

The achievement of these three critical priorities takes precedence in the near term over maintaining a balanced Federal budget. I believe you have said that as you have analyzed the situation here in the United States. I will not choose to quote you today, but will in the event we have a little extra time.

When you or those helping you pen items that explain something in a very good way, I save them—I "rat-pack" them—and then, every now and then, I read them and ask everybody to guess who said them because they are so good. The reason they are so good is that they are just like what I would say—but you are the Chairman, so you get to say it first.

In any event, I think we would all agree that I join the ranks of only a few who have worked the hardest to get a balanced budget and to maintain it. As a matter of fact, some people think I was kind of a wild man to spend so many years trying to get that done. I wish we had not had a terrorist attack, and I wish we had not had a few of these other things, and that we could have lived the luxury for 6 or 8 or 10 years of this budget situation that was upon us but for that.

This budget is tough enough. It achieves critical priorities, but it does not abandon fiscal discipline. Domestic spending grows, but the growth of domestic spending is kept particularly low. I am sure that every member of the Senate will find funding levels for their specific States or constituents or projects, programs, or activities that we will not like and that we will not be able to do.

Nonetheless, we will work as we always have to accommodate as best we can what Senators on behalf of their constituents in their States think we should be doing.

There is no question that we will have to work together, the Administration and Capital Hill, to produce a congressional budget that reflects the priorities outlined today. The OMB has made great strides in working to identify those programs that work and those that do not. You should continue this very good work, Mr. Daniels. There is no way out of it—that or some similar way of evaluating the program will have to be done by someone, and I personally look forward to what you think is the best way to handle the money that is left over after the three big priorities have done their job.

I hope we can extend the welfare program and focus on special items that do affect our families, such as the Bayh-Domenici proposal that encourages two-parent families. It is not a big program, but it is certainly something that we could say let us try to find the money to do that kind of thing.

I know that we can fund those programs that will secure our nuclear stockpile and make the world a safer place.

So all in all, this is not a usual year. This is a very unusual year. We are just coming out of a recession, and we are not too sure that we are coming out with a bang; it may very well be a slow, creeping, moving ourselves out of this recession.

And obviously, right while that is happening, we are dealing with terrorists about whom we must learn much more and about whom we must do a better job of seeking them out and ridding countries of them.

There can be no doubt—these two things happening simultaneously on the world scene is an enormous challenge to the American people, to our form of governance, and puts all of us in a very, very difficult, precarious situation.

Again I repeat—I wish we would not be using that surplus for the high-priority items that our President asks us to use it for, but I challenge anyone who wants to build a budget on priorities to find a better way. And I speak for everyone on my side of the aisle. We anxiously wait to see if you have one. I do not know whether it is possible, but we are all ears.

Thank you for calling the meeting so promptly in the year. Maybe this means that we can get our work done in a timely way. If that is possible, I will be here as much as I can to see that we move it in that way, with both of us pushing as we should, the Chairman and the ranking member.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Chairman Domenici.

I appreciate as always the cooperative attitude that you bring to the work of this committee and the extraordinary leadership that you have given the country over an extended period of time. And I want to acknowledge the fact that you have been one who wanted to make sure that we were fiscally responsible in this country and that we reduced deficits at a time when there were some very painful decisions to be made, and you were there. I want to acknowledge that.

I also want to say to Director Daniels that through you, I want to commend the President for his conduct of the war effort. On many occasions, he has made me proud as an American to watch the way he has conducted himself in these very difficult times.

Our disagreement is a fundamental disagreement over long-term fiscal policy. I do not have much disagreement over the budget for this year. There are obviously areas where maybe we could do things differently. My great concern is the long term and the fiscal course that he has put us on. I think it is a very serious mistake.

I do want to indicate that with respect to this war effort, the President can count on us on our side to respond to his assessment of the need. We are going to be with him shoulder-to-shoulder on providing the resources necessary to conduct this war. And our adversaries should understand that there is not an inch of room between us on that question.

The resources that the President requests to conduct this war and defend this country will be made available to him and to our armed forces.

With that, again, welcome, Mr. Daniels, and please proceed.

STATEMENT OF MITCHELL E. DANIELS, jr., DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DANIELS. Thank you, Mr. Chairman, and thanks to the committee.

Senator Domenici is right that we do not often get this mutual opportunity. I hope you will understand if I say that from this chair, it feels often enough, but as you know, I am always glad and grateful for the chance to be here.

As before, I would like to show what has become my customary mercy and dispense with the reading of the testimony which I have submitted and will gladly take your questions, of course. Let me just try to summarize it in the fewest words I can.

Before turning to the business that will probably occupy most of our time, I would like to commend to the committee's and the Congress' attention the differences in this budget. The outstanding career professionals at OMB have worked very, very hard on some changes and we think some progressive improvements that they have looked forward to for a long time. This goes to the notion of becoming serious about the better management of the day-to-day business of the Federal Government; becoming serious about differentiating, as the Congress has instructed the Administration's executive branch of government to do, serious about measuring performance, separating programs that work from those that do not work as well, strengthening the former by drawing on the latter. This will make a very serious attempt to begin, and we do hope that you will spend some time examining those features as well, helping us begin to broaden the question that we meet about here from simply how much to how well, from how much will the government spend to how much will the government achieve, and how can we all work together to improve that.

Mr. Chairman, the differences between now and the last time we met, even in midyear let alone a year ago, are of course profound. They do trace to the two events of a recession that, regrettably, no one saw and was already underway a year ago, and of course, to the attack on our country.

We present this week a budget to win a two-front war, and I very much welcome, as I know the President will, your affirmation of your support and that of I know your colleagues on the Democratic side of the aisle for the President's conduct of the war and the resources necessary to prosecute it. I think that Americans have really been uplifted in the last 3 or 4 months by the way in which the Congress has come together around that, and I thank you again for reminding us this morning that that will to win remains intact and bipartisan.

We are asking for fairly aggressive spending increases, at least on the discretionary side of the budget—9 percent—2 percent above what was agreed upon last year in more normal times. I would mention in passing that in part because of circumstance, in part because of reforms that this Congress has enacted, overall spending will grow at a much more modest rate of about 5 percent. This allows us, really, to deal with our new difficulties—our triple difficulties—of war, recession, and emergency while maintaining a fiscal posture and condition that our colleagues in other developed countries would envy.

The budget doubles spending—slightly more than that, actually—for the new category that we call "homeland defense." Here, as in the conduct of the war, the President's posture was to leave nothing to chance, and we do attempt to fund each of those activities that Secretary Rumsfeld and Governor Ridge on his front have certified to the President are required.

That having been done, we believe that it becomes especially important that we are very careful about the rest of the Government. We suggest that it grow, but at the modest rate in the overall of 2 percent. Most American family incomes will not grow by more than that this year; many, of course, are not growing at all in this recession. We think that this Government, that part not directly involved in the conduct of the war, can live with 2 percent, too.

The third priority of this budget is to attack the recession, which is the reason that we are not going to pay down debt this year as we would all like to do; which is the reason that our long-term best guesses as to total surpluses have changed. Here, the President says, as he has throughout his career, that while balanced budgets are a very fundamental objective of Government, there are three conditions which can justify temporary deficits—war, recession, and emergency. We have them all, and he would like to see the Congress pass the stimulus package that came so close to passage in December, or at least something very like it. We have made room in this budget for that, and our numbers do reflect the prospect that that will happen.

Let me say finally that we associate strongly with the points that you have made this morning and on other occasions, Mr. Chairman. You are absolutely right about the importance of maintaining fiscal discipline and doing all that we can over time to accumulate surpluses and devote them to the reduction of our national debt. We look forward to the resumption of that goal as soon as possible, and nothing will bring it on faster than a strong and early recovery; hence, the President's continued request for a growth package.

Nobody knows, frankly, what our long-term prospects will be. I will show you, if you want to dig deeper into the incredible range with which these projections have varied, even in recent years, the projection for this year over 10 years happens to be the second-biggest of all time. Everyone has focused on that it is different from last year, but if we had not made one last year, this one would now be seen as, I suppose, very, very encouraging. It is as large as the one made in the last Administration in 2000.

So the point is we do not know and we cannot know how big our surpluses will be beyond the short term into the future. It depends so very much on the return of growth and on sustained growth over a long period of time.

We look forward to working with this committee to make that, as well as victory in the war which circumstances have thrust upon us, a reality.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Daniels follows:]

THE PREPARED STATEMENT OF MITCHELL E. DANIELS, JR., DIRECTOR, OFFICE MANAGEMENT AND BUDGET

Mr. Chairman:

My colleagues at OMB and throughout the executive branch have worked hard to present this committee and our fellow citizens with a very different budget for the Fiscal Year 2003. Before turning to the traditional subjects of totals, balances, and specific policies, let me recommend to the Committee's attention some new features which I hope will now become part of your annual expectations and deliberations.

This budget takes seriously the assessment of government performance, and its relationship to future spending. Activities where effectiveness can be proven are maintained and often reinforced; those that demonstrably fail, or can make no showing of effectiveness, in many cases are looked to as sources of funding. The days when programs float along year after year, spending taxpayer dollars with never a showing of reasonable results or return, must give way to an era of accountable government. This and all future budgets must no longer be permitted to answer only "How much?" They must also address the question "How well?"

This innovation responds to decades of calls by good government advocates. While long overdue, it is especially necessary at a time when the physical safety of Americans requires that the Federal Government take on many additional, expensive tasks.

In the interest of both accuracy and sound management, this budget takes a major step toward full cost accounting of programs and departments by assigning the costs of health and retirement benefits to the places where those costs are created. At long last, the true cost of these programs will be visible, and managers will have full incentive to control the costs of additional personnel. Other disguised costs, such as the future liability associated with hazardous waste, remain and should be the object of further reforms.

The Unexpected Cost of the Recession

It has been clear for months—since September 11th to be precise—that our fiscal picture had changed in a fundamental way. The weaker economy erased $177 billion of revenues previously expected for 2002, and $120 billion for 2003. Additional spending to respond to the terrorist attacks in these years subtracted another $31 billion from the surpluses we all had anticipated. Over a 10-year period, for those still professing to find use in such numbers, changed economic and technical factors reduced the surplus by $1.345 trillion.

The recession that began in the first quarter of 2001 was the largest but not the only economic factor reducing estimated surpluses. The revised outlook for near-term productivity growth reduced the level of GDP—and hence the receipts base—throughout the budget window. Both the recession and the impact it has had on budget surpluses took us all by surprise.

As the *Washington Post* has noted, "2001 was a nightmare for economists," pointing out that, almost without exception, forecasters failed to see recession or its effects coming. In our misjudgments, our economists were in large and renowned company. The good people at the CBO, and 51 of the 54 private forecasters in the *Wall Street Journal* survey, all missed the recession even as it was well underway. The fact that our assumptions were toward the conservative end of the forecasting spectrum did not protect us from a very large misestimate. May I add that when the Nation's economists are having nightmares, budget directors lose sleep, too. We ultimately must choose assumptions that we believe will be accurate, and it is no comfort later that the rest of the world was in error, too.

The Administration stated from the outset that it would leave room for error, particularly when it came to longer-term projections. In mapping out long-term policy proposals, our Blueprint expressly marked off over $800 billion (15 percent of the total expected) as a Contingency Reserve in the event that the hoped-for surpluses did not materialize. At least as far as one can tell from the latest 10-year estimate, even this generous hedge was not enough.

The 2001 experience casts further doubt on the entire idea of 10-year budget forecasts. The attempt to see 10 years out began only 6 years ago—prior to that time 5-year forecasts were the longest ever attempted—but already enough evidence is in hand to convict. The experiment with 10-year forecasts demonstrates that no one can reliably predict budget levels this far into the future. In fact, despite all the lamentations, this year's 10-year baseline surplus forecast is just as big as that of 2 years ago; even after tax relief, it is the largest ever except for last year's. If we had taken a 1-year timeout from 10-year guesswork, no one would say that anything was "missing."

Our budget extends 10-year forecasts at the top-line level, for those still determined to find them credible, but it drops them from the rest of the document. There we return to the wisdom of our predecessors by using 5-year numbers, which are plenty uncertain in their own right.

A Two-front War Against Terrorism

Mr. Chairman, we present this week a budget for a two-front war. It proposes substantial increases, those the President believes necessary to deliver on the paramount duty of the Federal Government, to secure the safety of the American people.

Last year's budget began the reconstruction of a neglected national defense base, and that project continues now with new urgency. The President asks Congress to support a 12 percent growth in base defense funding, part of this reflecting the new threats presented by a long-term terrorist foe. He also requests an additional $10 billion, if needed, for the costs of continued hostilities at today's levels.

Funding for the category of activities we now term "Homeland Security" will double under the President's plan: airline security, first responders, bioterrorism, border security and preventive law enforcement, are all scheduled for major increases as recommended to the President by Governor Tom Ridge.

We have worked closely with the Office of Homeland Security to define and budget for these activities; an explanation of the definition of the Homeland Security budget is attached at the end of my testimony. We will guard against and oppose efforts to divert funds from Homeland Security requirements or to misclassify unrelated funding under Homeland Security's priority status.

Winning our two-front war is not optional, and will be expensive. As in other times of national conflict, tradeoffs will be required. Other priorities will have to stand aside for a time, lest we commit the "guns and butter" mistake of the Viet Nam era. We propose a very reasonable level that allows spending not related to the war or homeland defense to grow by around 2 percent.

Within this "Rest of Government" category the President proposes $355 billion of spending. It must be noted that the activities it encompasses have enjoyed rapid funding increases during recent years, growing by an average annual rate of more than 8 percent since 1998.

Within this enormous sum, it is both possible and desirable to increase high priority programs of proven effectiveness, and this budget recommends many such increases. Dozens of programs across the government are scheduled for growth based on demonstrated results.

Measuring Performance and Delivering Results

For decades, good government advocates have called for systematic measurement of government's performance, and its reflection in the allocation of resources. In 1993, Congress passed the Government Performance and Results Act (GPRA), which was intended to implement this reform, but this mandate has been virtually ignored. The President's budget for 2003 responds to Congress' instruction, differentiating where the facts are available between programs that work and those that do not.

Many programs of proven effectiveness are strengthened, by shifting funds from those which can make no proof of performance. NSF, WIC, Community Health Centers, and the National Weather Service are among the best performers, based on clear targets they have set and hard data that says these goals have been met or surpassed.

A serious attitude toward performance is long overdue, but takes on special urgency at a time when the demands of national security assert a heavy claim on our resources. We hope the findings of this budget will trigger interest in performance assessment, and bring forth much new information about that large majority of programs for which we have no useful data at all.

Restoring Economic Growth

This budget funds a two-front war, but takes aim at a third priority as well, the struggling American economy. The President urges the Congress to act, and act quickly, on a jobs and growth package like that which passed the House but was blocked in the Senate just before Christmas.

There are some encouraging signs of recovery, but the President is not satisfied to leave matters to chance. Government cannot "manage" the economy, but it should do what it can, and the President wants to act on a stimulus measure that might accelerate and strengthen recovery. While adding this action to his other budget proposals would likely make 2003 a year of a small deficit rather than a year of small surplus, the President favors the tradeoff in favor of jobs and growth. Past the short term, it is only rigorous economic growth that can restore surpluses in any event.

Conclusion

In sum, we should count our national blessings. Despite simultaneous war, recession, and emergency, we are in a position to fund the requirements for victory, plus a stimulus package, and still be near balance. The deficit we project will be the Nation's smallest in times of recession since the early 1950's.

Interest costs to the Federal Government will continue to decline; interest payments will fall below 9 cents of each budget dollar for the first time in 22 years. Despite everything, the outlook is promising for balance in the year after next, and for a return to large surpluses thereafter.

The President's proposals thus do what must be done, while protecting our fiscal future. It is a privilege to submit them for the committee's review.

THE HOMELAND SECURITY BUDGET

To develop the homeland security budget, the Office of Homeland Security and the Office of Management and Budget (OMB) identified those activities that are focused on combating and protecting against terrorism and occur with in the United States and its territories. Such activities include efforts to detect, deter, protect against and, if needed, respond to terrorist attacks.

As a starting point, funding estimates for these activities are based on data that has been reported since 1998 in OMB's *Annual Report to Congress on Combating Terrorism*, and include combating terrorism and weapons of mass destruction (WMD), critical infrastructure protection (CIP), and continuity ot operations (COOP)

In addition, homeland security includes funding for border securty (i.e. Immigration and Naturalization Service's enforcement and detention activities, Customs enforcement activities. Coast Guard's enforcement activities, the Agricultural Quarantine Inspection Program, and State's visa program) and aviation security.

Since homeland security focuses on activities within the United States, estimates do not include costs associated with fighting terrorism overseas: those costs are captured within the war on terrorism abroad category.

The budget uses the Combating Terrorism Report's definitions for combating terrorism and WMD preparedness, CIP, and COOP. Combating terrorism includes both antiterrorism (defensive measures used to combat terrorism) and counterterrorism (offensive measures used to combat terrorism), and includes the following five categories of activities as they directly relate to such efforts:

- law enforcement and investigative activities:
- preparing for and responding to terrorist acts:
- physical security of government facilities and employees:
- physical protection of national populace and national infrastructure; and
- research and development activities.

CIP is defined as efforts associated with enhancing the physical and cybersecurity of public and private sector infrastructures, especially cyber systems that are so vital to the Nation that their incapacitation or destruction would have a debilitating impact on national security, national economic security, and/or national public health and safety.

COOP refers to the capability of Federal agencies to perform essential functions during any emergency or situation that may disrupt normal operations.

As the Office of Homeland Security develops a comprehensive national strategy to secure the United States from terrorist threats or attacks, it may refine the definition used to establish the boundaries of this category.

Chairman CONRAD. Thank you, Mr. Daniels, for that testimony, and thank you for being here today.

While we stand shoulder-to-shoulder with respect to the defense of the Nation, we do have profound differences about the wisdom of the fiscal course that you and the President have charted.

It struck me today, looking at your budget, that if you were in the private sector and proposed a budget like this one, you would be headed for a Federal facility—it would not be the White House, and it would not be the Congress of the United States—you would be headed for a Federal correctional facility because it is violation of Federal law for a private sector entity to take the retirement funds of its employees and use them for another purpose. It is against the law to take the health care funds of its employees and use them for another purpose.

In fact, as I recall, the Reverend Jim Baker, who used to head the PTL organization, went to jail for raising money on one basis and using it for something else. In fact, he served his time up in our part of the country, in Minnesota.

The thing that I find most troubling is that in your budget, you are talking about just over the next decade taking $2 trillion out of Social Security, out of Medicare, and using those funds not for those programs but to pay for tax cuts, to pay for other Government expenditures.

I would be quick to acknowledge that I could live with that in a year of economic downturn and at a time of war, but you are not forecasting economic downturn even for later this year; you are forecasting economic recovery—and for the rest of this decade, you are forecasting rather strong economic growth. Yet, year after year, you propose taking money from Social Security, taking money from Medicare, to pay for even more tax cuts, making permanent existing tax cuts costing more than $400 billion in 2002 through 2011, every penny of which will come right out of the Social Security Trust Fund—something the President promised not to do.

How do you justify it?

Mr. DANIELS. Mr. Chairman, let me say first of all that you are a good guy and a person I enjoy. We are both baseball fans. And if I wind up in a correctional facility, you will be my cellmate, and that will be quite pleasant; and we will have a lot of company there because, as we have discussed before, nothing comes out of the trust funds under your approach or the President's approach. Every penny of Social Security and Medicare benefits of course will be paid this year and in all future years. We all know that. And the trust funds will be exactly as big—$1.33 trillion this year, $1.5 trillion next year—exactly as big, have exactly the same assets in them—namely, debt certificates—under any of these approaches, whether we have a giant surplus, exact balance, or some kind of deficit, it will not change by one cent.

As we have often discussed, the question is to what purpose will the extra funds that for now are coming in through payroll taxes and the interest that we credit on those taxes be put. So to use what I think is very inaccurate vocabulary, if we dip, you dip. The question is for what purpose do you dip. You would dip to pay off debt—a very good idea and a very high priority, but not as high, very honestly, in this Administration as winning the war against terror and defending Americans at home.

We talk a lot about things we must protect, and of course, Social Security and Medicare are at the top of that list, but with them, the most solemn responsibility of Government and the reason we have a deficit in this budget is to protect the lives of Americans.

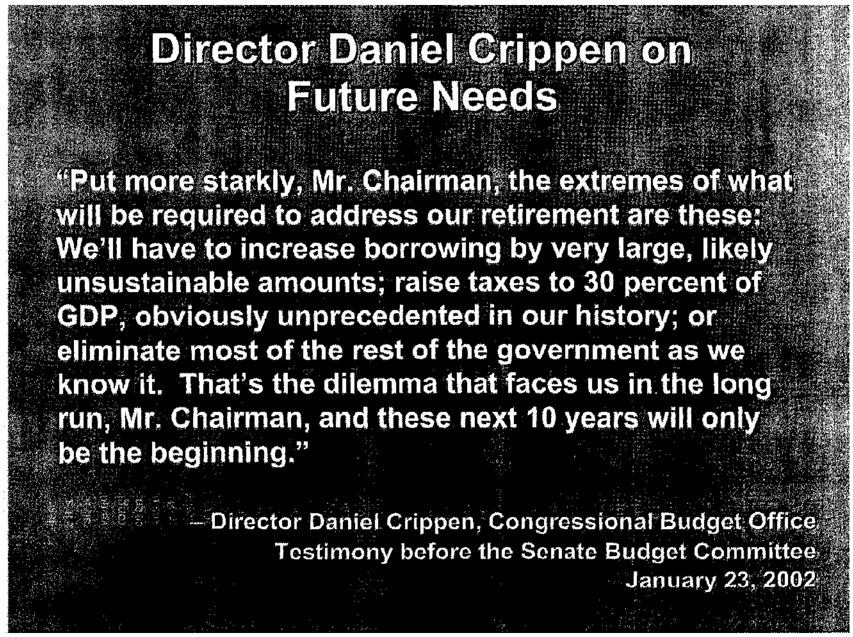
Let me just show one chart——

Chairman CONRAD. Let me just say before you do that—because we have a vote on now, and I am going to have to leave to vote; but we will have a rolling chair. Senator Murray went, she is voting, she will return. But let me just say, because I am going to have to go and vote, as will Senator Domenici, that we just profoundly disagree.

When you raise money from people from payroll taxes for Social Security and for Medicare, and you then take those dollars and use them to fund a tax cut and other spending, that affects the ability to meet the promise on Social Security because you have not used the money either to pay down debt or to fund reform of Social Security and Medicare.

In the budget that I proposed last year, I not only saved every penny of the Social Security and Medicare Trust Funds for those purposes, but I also designated another $900 billion to strengthen Social Security for the long term.

What you are doing is taking virtually all of the Social Security and Medicare money over the next decade and using it to fund other priorities, so it is not available to pay down debt, which would strengthen our position to keep the promise in the future, it is not available to reform Social Security or Medicare. The money is gone. And what we will be left with is what Director Crippen described—if we could just put that statement up one more time—because here is where we are headed with the course that you have charged.



"We will have to increase borrowing by very large, likely unsustainable, amounts; raise taxes to 30 percent of GDP, obviously unprecedented in our history; or eliminate most of the rest of the Government as we know it. That is the dilemma that faces us in the long term, and these next 10 years will only be the beginning."

Now, that is not my description of where we are headed. That is the director of the Congressional Budget Office's description of where we are headed——

Mr. DANIELS. Yes, but it is not his description of this budget. That is his description of where we were heading already given the long-term problems in our entitlement programs.

Chairman CONRAD. Ah, but Mr. Daniels, you do nothing but dig the hole deeper in this budget. You spend another $700 billion beyond the baseline; you have tax cuts of $600 billion more in 2003 through 2012. All you have done is dig the hole deeper and deeper, and you are leaving the country in a circumstance which USA Today describes as threatening our long-term financial security.

Now, look—I am with you on the war effort. I am with you——

Mr. DANIELS. Well, that is the money you just criticized us for spending.

Chairman CONRAD. No, no, no, it is not, no, no. I am with you on the war effort, but you have asked here to make the tax cuts permanent. The tax cuts you had last year were based on the notion that there were there would be $5.6 trillion of surpluses over the next decade. Now we know that that is not the case, that those assessments were overly optimistic. But now you come and ask for another $600 billion of tax cuts and $700 billion over the baseline on spending.

On the spending for defense, I am with you, I will support you every inch of the way, but I really cannot endorse—I think it is profoundly wrong; I think it is irresponsible to be taking $2 trillion out of the trust funds to pay for other things. And there is no plan here by this Administration in this budget except to dig the hole deeper. I just think that that is profoundly wrong.

Mr. DANIELS. Well, actually, to repeat, nothing comes out of the trust funds. They are just as big as they would be under any other circumstance.

Second, I do not know and you do not know—no one can know—what our 10-year prospects really are. Two years ago today, we thought there was $2.9 trillion—that was the forecast of the previous Administration—over 10 years. That was the biggest prospective surplus of all time. Again today, we think it is $2.9 trillion. To be honest—and we have said so in this budget—I think this experiment of the last few years of trying to forecast out that far is proving to be a pretty dead-end exercise, because the numbers wander all over the place. I could easily be back here next year with another $5.6 trillion forecast. It all depends on what we think happens to economic growth over that timeframe.

Chairman CONRAD. I apologize. We have less than 2 minutes left in the vote. I am going to go vote. Senator Murray will take over. The next round of questioning is on the Republican side. I do not know, Senator Smith, if you have had a chance to go and vote.

Senator SMITH. No.

Chairman CONRAD. OK. I will leave it in the hands of Senator Murray, and we will return as quickly as possible.

Senator DOMENICI. Senator Murray, before I leave—I am walking out right now and will take my turn in normal order—I just do not want to let the record stand with the statements made by the Chairman as if those who have been working on this for a long time agree with those assessments. I do not agree with them at all, so we will have our chance during the next couple of hours to try to explain why.

In the meantime, we will go and vote, come back and take our turn.

Senator MURRAY [presiding.] Senator Smith, do you want to vote and come back?

Senator SMITH. I will just take up one question, Senator Murray.

Mr. Daniels, thank you for being here. For my own clarification, if we vote to dramatically increase the agriculture budget, as advocated by the Chairman of this committee, won't that dip into the Social Security Trust Fund as he is describing it?

Mr. DANIELS. Yes, if you accept his characterization. There is $73.5 billion of additional agricultural spending contemplated in this budget that is consistent with the resolution of last year and the agreement of, I think, the two agriculture committees. And yes, exactly the same comments could be made about those dollars.

Senator SMITH. What I want to make clear is that what he is disagreeing with as I understand it are your spending priorities—he does not like the money going to the tax cuts, but he does like it going to the agricultural programs—many of which I support—but they both dip into Social Security as he defines this problem.

Mr. DANIELS. Yes. I will just say again that there is much we agree with the Chairman and his allies about. And we would like and we look forward to getting back to surpluses and devoting those payments—again, they do not go in a vault somewhere; they go to o ne purpose or another—he would like them to go to debt reduction, and so would we.

Let me just make a point for the benefit of the audience. We could have a surplus this year and continue to paying down debt. If that were the No. 1 priority above and beyond all others, this would not be hard to do. We have on our baseline numbers a $51 billion surplus. But that would mean that we would not rebuild our defenses and fight the war; we would not strengthen our homeland defenses—that will take you down to that 20 bar; we would freeze the rest of Government, including, I should say, the single biggest factor there, which is farm spending, to take you to balance, where it says minus 3 there. You could have a balanced budget even doing those things, but we propose that we do attempt to put America back to work sooner with a stimulus package.

Senator SMITH. I do suspect that given farm spending, which I support, and tax cuts, which I support, that tax cuts are going to be more stimulative to the economy and get us back to growth more quickly than the farm program.

Mr. Daniels, one thing I would like to ask you specifically is about a recent trip that I took with President Bush to the Youth Opportunity Center in Northeast Portland in my State. This is a valuable, effective program aimed at youth from 14 to 21 years of age, and about 1,400 youth are enrolled there. These are at-risk youth, and they are afforded the opportunity by the center to get back to school, obtain a G.E.D., or explore other workplace options. It was my impression that President Bush was very supportive of the program, but it is my understanding that the budget that you are proposing cuts the program that he visited and seemed to support.

I am wondering if you can explain whether this is really being cut, because the press is having a field day at President Bush's expense in my State.

Mr. DANIELS. Well, I am familiar with the program. As it stands, it is part of a pilot program that, like much in Government, was supposed to have a limited life span. Many such programs discover the secret of eternal life, it appears, and this one might become one of those.

The good news is on two fronts. One, there is a larger and permanent program for youth opportunities that involves State grants, very large ones, much, much larger than the program you are describing. And if this is a successful center, there is not a doubt in my mind that it will be funded through that ongoing program for youth opportunities.

The second piece of good news here is I believe there is bipartisan agreement on the need for more job training, particularly in a time of slowdown, and the President proposes a dramatic, about a $3 billion, increase overall in job training funds.

We would like to concentrate those funds in the programs that work best. We find 48 programs littered across the Federal Government in some very unlikely places, many of them, attempting to train Americans for work. We have identified 28 that seem to work pretty well, and we would like to concentrate the spending there. One of them is the Youth Opportunities block grant or State grant that I mentioned.

So I am sure that center is doing good things and will be doing them under the President's budget.

Senator SMITH. They are, Mr. Daniels, and I hope you will commit with me to one way or another make sure that this program is continued and funded, because it is working, and it is helpful. And through one fund or another, I am anxious that the President be able to keep his promise to the young people who are there. It is very, very important to me and to them and to our country that we get this kids back on the right road.

Mr. DANIELS. I am glad to work with you.

Senator MURRAY. Director Daniels, thank you so much for being here today.

In recent days and in your op-ed article that I read over this past weekend, you said that our country "will need to make sacrifices on the domestic front to pay for the needed investments in security." And, as you noted, ours is not the first generation of Americans to face this kind of challenge. Our fathers and mothers, our grandparents, and other generations of Americans have really struggled to protect America's freedoms.

In World War II and in the cold war, we faced a grave threat to our existence, and the people in my home State of Washington were asked to take up the challenge of the Manhattan Project. Throughout the cold war, the people of the Tri-Cities in Washington State produced the materials that went into our strategic arms. We won the war because of the sacrifice of the people in that community.

One legacy of that sacrifice is the freedom we enjoy today, but there is another legacy that really weighs on all of us in the Pacific Northwest, and that legacy is nuclear waste. We have one of the most polluted sites in the world, the Hanford nuclear facility on the banks of the Columbia River. I know that my friend and colleague from New Mexico shares my passion for this particular issue, and he has been just great to work with and to help and support us with this.

But unfortunately, President Bush's budget for the second year in a row underfunds the critical cleanup effort that is required at Hanford nuclear reservation. I think this is an example that is indicative of a larger problem with this budget. President Bush's priorities in this budget do not reflect the priorities of many Americans in this country, whether it is Hanford cleanup funds or Social Security and Medicare Trust Funds.

The truth is we all know that we are in this position in part because of the recession, in part because of September 11, and in large part because of the President's tax cut, which all of you told us would get us out of this recession.

Mr. Daniels, last year, when we heard rumors that the President's budget was going to cut Hanford funding, I called you, and you assured me that Hanford would not be cut; but when the budget came out, Hanford funding was cut and cut dramatically.

Mr. Daniels, I want to ask you this morning—do you agree that given the sacrifice that the people of the Tri-Cities have made to help us win World War II and the cold war that we now have an obligation to clean up the waste at Hanford nuclear site?

Mr. DANIELS. Absolutely, Senator, and the good news I hope is that this Administration in this budget has launched a substantial reform of what has really been a poorly run program——

Senator MURRAY. Are you saying that Hanford nuclear reservation has been poorly run?

Mr. DANIELS. I am saying that across the front of these environmental cleanups, it is unacceptable that we will still have nuclear waste lying around in 70 years, and that is the situation that this Administration found when it came to office. And in this budget, we propose, first of all, more spending; second, more importantly, a reform——

Senator MURRAY. I am sorry, Mr. Daniels. The way I read your budget, Hanford gets a lot less money in this budget.

Mr. DANIELS. Well, we will work with you to find the right amount of money, but the most important thing is how we spend it, and we have been spending billions of dollars. We have had $73 billion in projected cost overruns across the front of these sites. This needs to be addressed, and Secretary Abraham has an aggressive plan to do it.

The idea would be to get these sites cleaned up more quickly under new contracts, and if that costs a little more money in the short term, we will——

Senator MURRAY. Mr. Daniels, aren't you aware that there are contracts in place that if we do not fund them correctly to begin with, those contracts are going to cost us more in the future. If we undo those contracts, take our name away from them, they are going to be renegotiated; and I have never seen a contract renegotiated for a lesser amount.

Mr. DANIELS. Well, I would recommend you talk with Secretary Abraham about it. He has a very active plan. These arrangements, as I said, are frankly unacceptable and I think would be to you, too.

I do not know the end date for Hanford off the top of my head, but I know that many of the other sites would be sitting there for decades under the existing contracts. This is a terrible——

Senator MURRAY. Well, Mr. Daniels, I will remind you that there is a tri-party agreement in place, and we are under a legal obligation to clean up Hanford nuclear reservation. My home State of Washington has been on the verge of a legal challenge to this for years, and none of us wants to go down that road; but if we do not fund the cleanup of Hanford, it not only puts the lives of the people in the Tri-Cities at stake as well as the entire Pacific Northwest, it does not fund a legal obligation that we have that may well see a challenge from the State of Washington, and it is the wrong message to everyone that we are asking today to make a sacrifice for the war that we are in today—that we are not going to be there to help you when that war is over.

Mr. DANIELS. Senator, our objective is to see these sites cleaned up more quickly. I think that would be your objective, too.

Senator MURRAY. Well, it has been my objective and my State's objective, too.

Mr. DANIELS. This is not about how much money we can pour into bad contracts; it ought to be about how much we can spend more productively.

Senator MURRAY. Are you saying the contracts that we have in place at Hanford today are bad?

Mr. DANIELS. That is a question for Secretary Abraham. It is his plan that our budget reflects.

Senator MURRAY. Well, I certainly will ask him as well. But I will tell you, Director Daniels, that I will not let my State down on this. I am going to do everything I can to meet the obligation to the people of my State who sacrificed for our freedom.

If my time is not up, I want to ask you one other question. Your budget assumes a major reduction in transportation spending. In Washington State, we have the second-highest unemployment in the Nation right now. We have the second-worst traffic in the Nation. This is putting a huge economic burden on our families and our businesses. It means less productivity, and it means less efficiencies. Businesses are leaving my State right now because of the lack of investment in infrastructure and transportation. Cutting the budget by $9 billion is not going to help.

Does this Administration realize that transportation infrastructure affects our jobs, affects our productivity, and affects our future economic growth?

Mr. DANIELS. Yes. Let us start by dealing with some of those pesky facts, Senator. We have no discretion in this matter. Congress passed a bill—it was a good one, by the way; I think you voted for it—that matches spending with transportation tax and fee income, and we simply apply a formula. The Departments of Transportation and Treasury do that, as you know. And last year, that led to a gigantic increase in transportation spending, in highway spending specifically.

Under that formula which Congress prescribed, as applied this year, we discover that we got way ahead of ourselves—$4.5 billion ahead of receipts last year. And we have simply faithfully applied the same formula that led to a $4.5 billion—I will not say "windfall"—let us say "advance"——

Senator MURRAY. Investment in infrastructure.

Mr. DANIELS [continuing]. Well, let us say "advance"—and now we are catching back up.

The bill that Congress wrote is a good one. It has led and will lead through the end of this budget year to $9 billion in additional highway spending over the previous system. Up until a few years ago, as you know, gas tax revenues and other transportation revenues were used for other purposes, and you fixed that, but——

Senator MURRAY. My time is up, Director Daniels, but I would just say that we did have an opportunity in this budget as presented by the Administration to help make up some of that shortfall if the priority was there from the Administration and understanding that investing in our critical infrastructure, our roads, our bridges, our highways, not only would help jobs today, which is an important part of economic recovery, but also would provide critical infrastructure for economic development in the future.

Mr. DANIELS. Well, we agree with the beneficial aspects and the importance of this spending. Over the 2-year period, the same amount of money will be spent, much more than previously. And incidentally, you might be happy to know that because we are talking here about how many new projects to start on an outlay basis—how much is spent, how many miles are actually paved, how many people are actually employed—it is virtually identical to last year, or I should say that fiscal year 03 will be identical to the current fiscal year.

So we think this formula that Congress wrote is a good and fair one. We have simply applied it as the law requires we do, but I think it is a little unseemly for road builders and others, who loved it when it led to a giant increase, an accelerated increase, to protest when the same formula corrects itself.

Senator MURRAY. I am not a road builder, but I do care deeply about my State and its ability to have the infrastructure it needs for the future.

Thank you, Director.

Mr. DANIELS. Thank you.

Senator MURRAY. Senator Gregg.

Senator GREGG. Director, as I was listening to this discussion, there seems to be a bit of a refrain that it is the tax cuts that are generating the reduction in the surplus and the deficit. And I have not yet heard anybody from the other side other than Senator Kennedy suggested that we should increase taxes, but that would appear to be the logical conclusion of some of the statements from the other side if they are going to continue to allege that it is the tax cuts that caused the problem.

Let me just ask you a couple of questions on that point specifically. If I look at these budget numbers correctly, the Social Security surplus is $161 billion this year, $160 billion next year, and $178 billion in fiscal year 2004. The tax cut this year would represent $38 billion; in fiscal year 2003, it is a $91 tax cut; and in fiscal year 2004, it is $108 billion.

So clearly, to the extent the Social Security surplus is being used, especially in this budget that you have presented, the tax cut represents a fairly small percentage of that, if you want to argue in those terms, and the larger percentage if obviously spending by the Congress.

And as I listen to the members of this panel discuss this issue, it is clear that spending may not be enough according to some members of this panel. So it is an inconsistency that I think needs to be pointed out.

Second, there is the argument that what we have lost here is the ability to reduce the national debt, which is true, by losing the surplus. But on the other side of the coin, if you eliminate the tax cut, you appear to be hitting the American people with a double hit—not only do they lose the reduction of the national debt, which is unfortunate, but they also lose getting the money in their pockets. Where does the money go? Well, it is going to be spent under the discussions that have been stated here. Any reduction in the tax cut clearly is going to be used for new spending; it is not going to be used to exaggerate the surplus, because under the numbers that we are looking at, $38 billion for this year, we would not cover the deficit—you would have to spend it.

So there seems to be an inconsistency and a contradictory view there. I would be interested in your general reaction to these statements which we have been hearing.

Mr. DANIELS. I will not attempt to interpret the criticisms of the tax cut as a call to increase taxes, but there is some data that might be of some use, if I can get a little help.

Senator GREGG. I am especially interested in your comments on whether we should leave the money in the American people's pockets as a tax cut versus taking it back into the Government and spending it.

Mr. DANIELS. I think you can guess my view on that, and I think it is particularly interesting to ask the question exactly whose tax cut would you take away—is it the single mother at $25,000 who, if we took the tax cut away now, would lose $305 in the next fiscal year? Is it the dependent child care credit that we would take away? Is it the marriage penalty repeal that we would reinstate? But the question is rarely asked that way.

Let us just note that across this time horizon, revenues are growing very fast. Revenues are growing by 55 percent. And the tax cut itself makes very, very little difference in that for some time. Less than one-quarter of the tax relief comes in the first 3 years and only 40 percent in the first 5 years.

So for those who believe that the American public is undertaxed, there will be multiple opportunities to espouse that point of view. Let us just look at where we stand as a taxpaying citizenry.

After tax relief—after tax relief—the take on the American public remains historically high. The post-war average on the red line—you can see that we are still above it and will be consistently throughout this time period after the tax relief. It was necessary simply to hold the take on the American people at 19 cents on every dollar this economy generates. If I showed you the same chart for individual income taxes, you would find it remains at all-time highs after tax relief.

So the President's point of view would be that our problem is not a lack of revenue or the fact that the American people are not being taxed aggressively enough. Our issues really are those of controlling spending and certainly of making sure that high taxes do not strangle the economic growth on which alone our hopes of big surpluses rest.

Senator GREGG. On the first part of your comment there on the issue of economic discipline, as you know, the caps have been adjusted, and the caps have lapsed, and we have basically shredded the caps. And we have no enforcement mechanism on the economic discipline side.

I am wondering how the Administration would react—assuming the Administration's budget were put in place—setting a new set of caps which would mirror the spending numbers in the Administration's position and putting in enforcement mechanisms such as sequester, which would be effective to enforce those caps.

Mr. DANIELS. Yes, Senator, we would be very amenable to that. The caps that have just expired, although they were often violated and were sort of a crude instrument, did have a beneficial effect, and we do believe the President would like to see some new mechanism put in place. The one that he has consistently proposed is to make the budget resolution a law, one that he would sign that would have binding effect probably stronger than the caps of old, and we would be happy to work with the Congress on that. Doing that would accomplish the goal that you just mentioned of locking in spending at the levels agreed to.

Senator GREGG. I doubt that we will go the route of making it law, although I would be amenable to that in some ways, and when I served as Governor, of course, that is the way the budgets worked in the States; in almost all States, the Governor signs the budget. But I would be interested in getting some other proposals on caps and mechanisms for enforcement from you folks. I think we need to move that type of language with this budget resolution or possibly with other opportunities that are going to come at us here.

Thank you.

Chairman CONRAD. Senator Feingold.

Senator FEINGOLD. Thank you, Mr. Chairman, and thank you, Director Daniels, for being here today to present the President's budget. We have had the document for less than a day, so I look forward to examining it in detail, but already an overall view of it gives me some concern.

As others have noted, the President's proposal would result in deficits for each of the 5 years covered by this budget, and I understand that it is also likely that it would result in deficits for each of the next 10 years as well.

This obviously is a tremendously different budget landscape from the one that was presented to us last year. CBO Director Crippen told this committee just a few days ago that there has been about a $4 trillion deterioration in the 10-year bottom line over the past year. Some of it is due to the slowing economy, but we also know that most of it was due to the spending and tax cut policies that were actually enacted last year. Only a fraction of that was in response to the terrorist attacks, and as the Chairman ably pointed out at the beginning, the great bulk of those policies came long before September 11.

It is crystal clear that the policies enacted last year have resulted in a greatly diminished budget position, a greater debt burden for our children and grandchildren, and that in many ways, it has squandered the opportunity to address the long-term challenges of Social Security and Medicare, and I would certainly add to the list the very important and looming problem of long-term care.

I regret that in too many ways, this budget proposal really offers more of the same. And clearly, some of us have a much different view of the direction we should be taking with the budget than the Administration, but I do look forward to a fuller discussion on our budget priorities as the committee works toward a budget resolution.

On the positive side, though, I do want to take this opportunity to praise the Administration for their efforts with regard to earmarked unauthorized spending. Many of us on the authorizing committees enjoy our work very much and look forward to playing a role in reviewing proposals for authorizing spending. When a program is included in an appropriations bill without having been vetted by the authorizing committee, there is a much greater possibility of mischief. And beyond that, by ducking the usual scrutiny of the authorizing committees, these earmarks not only open the door to wasteful spending, they also undermine funding for other worthy programs.

Let me note that many of these earmarked programs may well be worthy of taxpayer support. But taxpayers are better-served if proposed spending is subjected to regular congressional scrutiny and, whenever possible, a more competitive process. So let me applaud the Administration's efforts to crack down on this kind of earmark, and let me know what I can do to join in the effort.

In that regard, I wonder if you could give us an idea of just how big the problem is of these earmarks.

Mr. DANIELS. I appreciate your comments very much, Senator, so let me just say that that makes two of us, and as far as I know, there may only be two of us.

I believe this problem has to be kept in some perspective. Each time we have raised it, we have done so really in the context not of the phenomenon itself, which is as old as the Republic, but of the explosion in special projects over the last few years. We have now reached a state where in 5 years, they have multiplied 700 percent—7,803 of them that we can find in the budget just passed. We simply suggest that this trend ought to be flattened or moderated, and we are not having much luck with that so far.

I do think that it is not good government, generally, to earmark; in some cases, 100 percent of the funds in programs that Congress has authorized have been earmarked. There is literally nothing for the executive branch personnel to do, because each dollar has been steered to some specific place.

So we would hope in a reasonable way to simply persuade the Congress to rein this in. It has been with us and I am sure always will be, but we do think it has gotten out of hand, and we appreciate your advocacy very much.

Senator FEINGOLD. Are there any concrete steps that the Administration is likely to take to try to deal with this problem that you can outline?

Mr. DANIELS. I would like to proceed through reason and compromise, and as I said, it has not proven particularly successful so far, but we do hope that continued dialog will do a little good.

Senator FEINGOLD. Let me suggest you might need a little more than that, and perhaps we should discuss some alternatives.

Mr. DANIELS. I very much appreciate your advice.

Senator FEINGOLD. The other question I want to ask has to do with the fact that I know that the President supports moving to a biennial budget, and that is something that I have advocated and am pleased to join our distinguished ranking member as a cosponsor of the legislation that would move us in that direction.

Could you say a little bit about why the President does favor moving to a biennial budgeting system?

Mr. DANIELS. Senator, the President does believe it would be an important reform, and given the size at $2.1 trillion of spending now, the complexity with over 2,000 separate programs and activity categories to deal with, and given the need to do a better job at oversight by the Congress as well as management by the executive branch of all those dollars and programs, if we were somehow able to agreed to this reform, it would leave more time for the Congress and for the Administration to tend to how the dollars are spent.

Last year, obviously, events intervened, but once again, it was Christmas-time before we had the budget, and the Congress' and ours was consumed overwhelmingly with simply getting to that point.

So trying to accomplish that in 1 year and being able to devote the rest of the time of a biennium to seeing that the money is spent well I think would be a great step forward. I know there is a lot of good faith opposition to the idea, but I appreciate your keeping it afloat.

Senator FEINGOLD. Thank you, Mr. Director.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Clinton.

Senator CLINTON. Thank you, Mr. Chairman.

I appreciate the comments that the Chairman made in response to this budget. Obviously, all of us are still digesting it as is the case with a very large and complicated document such as this. But I am particularly concerned that there is no direct reference to aid for New York in the Budget. And yesterday, Director Daniels, in discussing emergency aid for New York, you said, and I quote: "It seems strange to me to treat this as a money-grubbing game."

Now, I have to tell you that we were shocked by that, and the shock was felt throughout New York; it was in the headlines of our newspapers, and the tabloids obviously had a field day with it, because it was so unbelievable that something like that would come out of the mouth of the OMB Director.

Clearly, we have all recognized that the September 11 attacks on New York were an attack on America. The majority of people who lost their lives that day were from the New York area—not all New Yorkers, but certainly predominantly. And New Yorkers were heartened on September 20, when the President promised to rebuild New York.

Now, I know that the President is scheduled to visit New York tomorrow to salute the heroism of our police and firefighters and our first responders, and I appreciate your including the picture of Ground Zero and the firefighters in the budget. But my first question is do you speak for the President when you call New York's request for emergency disaster aid a "money-grubbing game"?

Mr. DANIELS. Well, Senator, it is a very fair question. I remember that Winston Churchill once said that he frequently had to eat his words, and in general, he found it a wholesome diet; so maybe I am in that position.

I regret if my comment was misconstrued, so let me tell you exactly what I think, and I think it is consistent with your views.

The President's commitment to $20 billion of aid is both inviolate and, frankly, well within our view. It will take some years to get there because the commitments that the Federal Government made, the unprecedented commitments of support—100 percent funding of infrastructure and other rebuilding and so forth—will in many cases take years to complete, and we will not know the real tally until that happens. But I do not have any doubt at all, as we have often discussed, that that will substantially exceed $20 billion, and it should.

I expressed in a poorly chosen word, I think, only this frustration—I have been in lots and lots of meetings, and we are working hard on this; you have held our feet to the fire, and that is as it should be—that in many of the meetings with either reporters or advocates for New York, it is hard to get to the question on what are we trying to get done. People want to sort of start and stop with how many dollars.

For instance, it would be terribly wrong if we got to some magic tally of $20 billion and quit and said, "Good. Case closed."

Senator CLINTON. Well, we do not expect that.

Mr. DANIELS. Right. And we do not intend that.

So that is all I really meant, was let us try to focus more often on what are we going to get done together.

I will give you the best example, as you well know, of some unfinished business. The President supported the Liberty Zone concept, $15 billion of investment that would be triggered by guaranteed loans for New York. It was in the stimulus package that did not quite get across the line in December, and we ought to get that done. That is the biggest missing piece now in a total package that is, again, I assure you, going to go well beyond $20 billion.

Senator CLINTON. I appreciate that clarification, and I will certainly work with you and the Administration and our colleagues here in getting that Liberty Zone tax policy through, because I agree with you—I think that is one of the missing ingredients.

But I also just want to clarify for the record, Director Daniels, that you are therefore not counting the victims' compensation fund as aid for New York. That is a different category which is mandatory spending; is that correct?

Mr. DANIELS. Well, it is. I think that when history writes the story, it would be only fair to recognize this again unprecedented expression of compassion and support from the rest of the American taxpayers——

Senator CLINTON. I agree.

Mr. DANIELS [continuing]. But I think we are going beyond $20 billion before and without counting that. And please tell New Yorkers we love them, we admire them, and we are going to keep the President's commitment to the last.

Senator CLINTON. That is very welcome news, and I appreciate that tremendously.

I just have a few other specific questions, and again, this may be easily answered in the budget, but I would like your guidance.

I do not find in the budget any commitment to fund the SEC pay parity which Congress passed authorized increases for in December. And certainly in light of what we are going through now with Enron and the accounting issues that are being raised, it is very difficult to imagine that we are going to get the staff assistance that we need and keep down the employee turnover without that SEC pay parity.

Is that in the budget, and I am just missing it, or is that a commitment that we can count on from the Administration?

Mr. DANIELS. A first step toward higher pay and perhaps 1 day to parity is clearly in the budget. We have $19 million, as I recall, in unspent funds that we have authorized using for this purpose, as well as some new money. Going straight to parity by the definition at least of some people would lead to a dramatic increase in spending, and we do not think the case has yet been made, at least for what some people are calling for—dramatic, 20-plus percent increases for the entire agency. But we have had extensive conversations with the Chairman—he is an advocate of doing more faster than this budget suggests—and we will be working with him over the days ahead to make sure he can keep the best people he has. We want him to be able to reward the best people that he has. Their work has never been more important.

So I would characterize this budget as taking a first step, and we anticipate it is only the first step.

Senator CLINTON. Well, Director Daniels, I would just refer you to the legislation that we passed. Obviously, the Congress believed even before the Enron/Andersen matter was quite as difficult as it appears to be that we should have parity with other regulatory agencies such as the FDIC. I think it is certainly critical to be sure we do have the resources, so I hope that that can be moved on quickly.

If I could, one last issue that I am concerned about—I am concerned about a lot of issues, and I join my colleagues in their concern about job training and Federal highway funding—but I was surprised to see a dramatic reduction in Federal payroll tax revenues for the Federal unemployment system.

As I read the budget, you are calling for a dramatic decrease in the annual payment per worker to support Federal and State unemployment, and in effect shifting much of the responsibility for funding unemployment operations onto the States. Is that a fair reading of the budget as it currently is?

Mr. DANIELS. Secretary Chao—and she is only the most recent person to propose this kind of reform—does suggest that we do undertake a fundamental reform of unemployment insurance to make it more flexible and to make it more effective, and accompanying this reduction would be a return of $9 billion in funds that have been collecting in the Federal fund for this to the States which we think they could use to begin strengthening their local systems as they see fit. We would like to see the States take over administration—actually, they have the authority or the responsibility for administration now—we have this sort of jury-rigged arrangement where the money comes to Washington and is then metered back out.

So we think that at the same time that we—I hope—extend unemployment benefits to workers who lost their jobs in this recession, we ought to clean up and reform the system that gets those benefits to them.

Chairman CONRAD. The Senator's time has expired.

Does Senator Snowe seek to use her time now, or would you prefer that we——

Senator SNOWE. Are you going to go one more round? Who was here previously?

Chairman CONRAD. Senator Hollings is next on our side, but you are next on your side, and we have been going back and forth.

Senator SNOWE. Senator Hollings can go ahead, and I will follow him.

Chairman CONRAD. All right.

Senator HOLLINGS. Thank you, Director Daniels.

Is it the case that you have attested that you project for 2002 a deficit of $106 billion?

Mr. DANIELS. Yes, sir.

Senator HOLLINGS. And yet I am looking at page 417 of your budget, and you show that the debt goes from $5.770 trillion to $6.137 trillion. In other words, the debt goes up $367 billion; yet you say it only goes up $106 billion.

How do you explain that?

Mr. DANIELS. Both of your statements are correct, Senator. You correctly point out that when we also add to the operating deficit of the Government those accruing interest obligations we owe to the various trust funds, as we should, the overall or the gross debt, as we say, of the Federal Government does increase by that amount.

Senator HOLLINGS. Well, those interests costs, turning to page 347 and 348 of your allied document, you show the interest as credited to each one of the trust funds; is that correct?

Mr. DANIELS. Yes, sir.

Senator HOLLINGS. And then, on page 348, we find out that it is deducted from those in order to lower the deficit. In other words, you accredit it to the trust fund and then you accredit it to lowering the debt. That is correct, isn't it?

Mr. DANIELS. Well, sir, I think you have very helpfully drawn our attention again to the growing obligations that we have—the solemn obligations, but growing—in the various trust funds of Government, and that is accounted for in just the way you stated it.

Senator HOLLINGS. But that is a double entry. That is the kind of Enron bookkeeping that we are all looking at; isn't that right?

Mr. DANIELS. I do not agree with the characterization. It is the way the Government has always done this, and both numbers, of course, are accurate, and both are sound.

Senator HOLLINGS. Well, the debt is the debt, and as to how much the debt goes up, you sh ow it going up $367 billion, not $106 billion.

Mr. DANIELS. Yes, sir.

Senator HOLLINGS. And the only way you can get down to $106 billion is to accredit the moneys to the trust funds on the one hand and then take it away on the other. You count it in two places—you count it to the trust fund, and you count it to the overall debt. That is double entry. That is exactly how you can—well, in fact, they wrote an article last week in Business Week entitled, "Who Else is Hiding Debt?" I looked to see whether our names were there, because we have been doing this in the Congress for quite some time, hiding the debt.

The truth is that when you use the Social Security Trust Fund, under Section 13.301, you are forbidden to report a budget that includes the Social Security Trust Fund; isn't that correct? That is Section 13.301 of the Budget Act that we passed almost unanimously. There was only one dissenting vote in this committee when we passed it, because we were trying to get at that double accounting, and we accounted for Social Security, and then we accounted to reduce the debt, and that is exactly what we are talking about—hiding debt. That is the big problem right now with Enron; they hid the debt all the way down to the last quarter, and then it all collapsed. Isn't that correct?

Mr. DANIELS. Well, I do not think it is exactly hidden, Senator. You just found it and read it to us quite accurately. We will be dealing with it again fairly soon—"it" here being the gross debt of the Federal Government—we will be dealing with it fairly soon, because we will be bumping up against a limit that relates to that.

Some have suggested, and it is being suggested again now, that we ought to concentrate on the debt that Senator Conrad quite rightly wants us to pay, to pay down the outstanding debt, the public debt of the Federal Government, and that we ought to make that what we limit so as not to mix these concepts. But both are very important, and I appreciate your drawing our attention to them.

Senator HOLLINGS. Well, these trust funds—we owe them some $2.335 trillion right this year and next year—these are CBO figures, and maybe you would contest them; I do not know—$2.558 trillion. Isn't that correct?

Mr. DANIELS. That is about right, yes, sir.

Senator HOLLINGS. That is about right, and that is what the market is looking at. If the debt is going up, and the interest cost goes up under your particular budget to $440 billion—it is right at $360 billion right now, and under your budget, it goes up to $440 billion—that is over $1 billion a day, and that is the first thing that Wall Street will say wait a minute—that Government is coming in here with sharp elbows, and they are going to be borrowing money, crowding out private capital, and they are all talking about consumer confidence, consumer confidence—it is market confidence. Isn't that our problem—paying down the debt? We did that for 8 years, it gave us an economic boom, and now we are increasing the debt—more tax cuts, more giveaways here, more tax cuts there—we eliminate all the revenues, and the debt goes up; isn't that correct?

Mr. DANIELS. In general, your points are well-made. Just for clarity, we will not be crowding out all that in the marketplace. We will have to borrow about $180 billion, which is flat, by the way, with last year.

One of the many points of comfort that the committee should take and the American people should take about our current fiscal situation is that, thanks to the good work of the past, interest costs, the dollars we actually pay out, are not growing, and it is one reason that total spending is kept under some control. Because of debt paid out in the past and lower rates, we are going to spend only about the same amount, $180 billion versus $178 billion, in actual interest costs.

Now, the rest that you are talking about is a paper transaction. We credit faithfully interest to all the trust funds of the Government, some 109 of them, and that is an important number to keep an eye on, too. I will tell you what it really tells us. It tells us that we do not solve our long-term Social Security and Medicare problems simply by paying down debt. If we do not reform those systems so they can meet those obligations, we will not be able to tax our way or borrow our way into solvency 1 day.

Senator HOLLINGS. But the point is that we really hide the debt, because the debt actually goes up $367 billion, not just $106 billion.

Mr. DANIELS. Well, we did not hide it too well, Senator. You did not have any trouble finding it—and thank you for identifying it for us.

Senator HOLLINGS. Thank you for acknowledging that, sir.

Mr. DANIELS. Yes, sir.

Senator HOLLINGS. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Snowe, and then Senator Nelson.

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Director Daniels. I certainly want to commend the Administration for making the economic stimulus plan one of the centerpieces of your budget, and I notice that that is outlined as one of the three major objectives of the President's budget, to obviously try to stimulate a recovery even though there are at least some initial signs to suggest that we might be emerging from this recession.

Two weeks ago, Chairman Greenspan testified before this committee, and he mentioned the fact, in response to whether a stimulus plan would be necessary, that the economy will recover in any event—although in response to my question, he also went on to say that with the potential that the economy more tepid that we would like later on this year, some form of stimulus program probably would be useful.

It is interesting to note in the CBO projections of the surpluses and the decline in surpluses and economic growth that primarily in the next 10 years, the loss of surplus is occurring in 2001 and 2002 as a result of the recession and obviously what occurred on September 11 and the associated requirements to meet that challenge.

That is why I happen to think in looking at those numbers that that is pivotal to enacting a stimulus plan the type, of course, that would produce a change in short-term behavior, because if in fact those numbers are correct even to a large extent, it means that we have to do all that we can right now to turn the economy around and have an impact on the deficit-surplus picture in the short term that obviously would affect the long terms, because they project even higher economic growth than they did a year ago for years beyond 2005 to 2011.

So I really do think that it is going to be essential to pass a stimulus package, and I know that many of the economists in the Administration have projected that we could double our economic growth, that we could produce 300,000 jobs—I think that was a White House projection—if we passed a stimulus package.

To what extent have you factored this into the budget, and how essential is it to pass a stimulus plan to recover in terms of job creation?

Mr. DANIELS. Senator, the President would agree with you that this is worth doing and is important to do—not to leave it to chance. There are very encouraging signs that recovery is coming, but not sufficient for him to believe that it is smart for us to rest on our oars or trust to luck. If we can do something soon and something truly stimulating—I think it is very important that any measure that Congress passes actually have at its core the creation of new jobs—but if we can do that, the President very much favors it, and let me just illustrate the tradeoff it involves. We talked about it briefly earlier.

We could have a surplus this year without question in our numbers, and we could use that money to continue paying down debt as we want to do—but three other priorities come first. If we want to wage the war on terrorism aggressively, if we want to defend our homeland, we will need to spend some money. That is the second bar from the left. The rest of Government, although we propose that it grow slowly, we still suggest that it be allowed to grow at a couple percent, and that is reflected in the third bar from the left.

Then comes the stimulus plan. We would be in balance but for the stimulus plan. So it is a tradeoff. You will not be surprised to hear me say how little I like red ink; I probably have as much aversion to it as anybody in the room, including your Chairman. But the President would agree that under these circumstances, the best thing to do short-term for people who are out of work today or whose jobs are threatened, and long-term in terms of getting us back on a path that produces big surpluses, is to act and act soon.

Senator SNOWE. That is certainly the view that I share, because frankly, I am concerned about what type of recovery. It could be a jobless recovery as some have suggested, similar to what occurred in 1991 when we were emerging from that recession. So that is why Chairman Greenspan said if you have a tepid recovery, which is in all likelihood, clearly, the kind of stimulus package that we would pass now—not 4 months from now or 5 months from now; it should have been done months ago, and it has not happened—clearly could have a material impact on the type of recover. Would you agree?

Mr. DANIELS. Yes, ma'am.

Senator SNOW. In addition, one other issue that Senator Stabenow and I have worked on consistently in this last year, along with Senator Bayh and others, is the issue of the trigger mechanism. Frankly, I feel even more convinced that this is absolutely essential for economic well-being and our fiscal health.

Many people talk about Gramm-Rudman-Hollings and say it was not an effective mechanism. If you look at the numbers in terms of controlling fiscal spending back then, 5 years prior to Gramm-Rudman and the 5 years after, it was a dramatic turnaround in the impact that it had in terms of the growth of spending.

So I think it is important that we move in that direction. In fact, those numbers would suggest that in the 5 years preceding Gramm-Rudman, discretionary spending grew by an average of 8 percent annually and 47 percent overall; in the 5 years after, it grew only 2 percent annually and 11 percent overall.

I think the point is that last year, we were talking about 10-year projections, and we were worried about the 10-year projections. Now, we saw $4 trillion evaporate in 1 year, obviously for circumstances that we could not foresee or anticipate—but that is the point. That is the point of having a mechanism, and in fact, Chairman Greenspan was the one who suggested a year ago to our committee—in his testimony, he reiterated his support for a mechanism that would be automatic; it would have to be something that Congress would have to take a proactive stance on through a vote in both the House and the Senate of some kind.

Why are you reluctant to support this kind of effort which clearly would make it, I think, a responsible approach to controlling spending as well as on the tax cuts? This is future—we are talking future—we are talking about future spending, before new spending kicks in, if we do not meet our debt reduction goals. And this would not be done now. It would start in several years.

So what would be wrong with moving in that direction now?

Mr. DANIELS. First, Senator, I salute your leadership and your commitment to long-term fiscal prudence. This is something that we share, and I know that every member of this committee does.

We worry about this particular mechanism being inappropriate to the mission. I think the single biggest problem that we find with it is that it would be, as the economists would say, pro-cyclical. It would deliver the wrong medicine at the wrong time. As we have just discovered, we get deficits when recessions come. The one we are in now happens to be the smallest one post-war, but each time a recession comes, we have found ourselves in deficit, and that is exactly the wrong time to trigger higher taxes; it is exactly the right time when you would want tax relief for the American people.

So we think that although it has the best of intentions, it could have perverse and anti-job, anti-growth effects.

Second, I think we need to be careful and ask ourselves if we create this trigger and pull it 1 day, who gets hit. The changes that are coming over future years have a lot to recommend them in terms of justice. I am thinking here about child care tax credits; I am thinking about the end of the marriage penalty and the other scheduled reforms that I think it would be very unfortunate if they were triggered off, particularly if we did not get better economics as an output.

Last, I read very carefully what Chairman Greenspan said, and he plainly said that Congress might consider some mechanism that would sort of force the discussion—that did not automatically create an outcome, but forced a debate, a discussion, and votes about reexamining various things. Congress has that opportunity all the time, and will have every year.

As I showed on one chart earlier, for those who believe that the tax relief was a bad idea and should not occur, the vast majority of it has not occurred and will not for years. So there will be multiple opportunities to choose higher taxation on an already heavily taxed public if that is the will of Congress.

Senator SNOWE. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

Mr. Daniels, I would like to ask you about that tax bill. Under current law in the present tax bill, how much does that tax bill cost us over a decade?

Mr. DANIELS. $1.345 trillion.

Senator NELSON. And when you add debt service——

Mr. DANIELS. I am sorry, I have given you an inaccurate number, but it is in that neighborhood. And debt service would add on top of that another $200 to $300 billion.

Senator NELSON. The figure that I have seen is about 1.6 that has been published here.

If you then make the tax bill permanent in the 10th year—which in the cycle that we are looking at is the last 2 years of this 10-year cycle since we are starting with fiscal year 2003—what is the cost of that tax bill over that 10-year period?

Mr. DANIELS. It would add another $345 billion, as I recall.

Senator NELSON. So it is getting into the range of about $2 trillion; that is basically the cost?

Mr. DANIELS. Or the benefit to the taxpayers of America—depending on your point of view.

Senator NELSON. Yes. I am just trying to—I am not putting any editorial comment—I am trying to get addition and subtraction to understand where we get with regard to this budgetary deficit problem.

Mr. DANIELS. Yes. I just flinch a little when we call it a cost, because from the taxpayers' point of view, it is more money they get to keep; it is only a cost when you look at it through the Washington end of the telescope.

Senator NELSON. I understand, but looking at it through the Florida end of the telescope, I have a lot of folks who are telling me that they do not like deficit financing. They are telling me that they would like us to balance the books, and they are telling me that they had every reason to believe that we were going to balance the books, and now we are not.

So looking at it through the Florida end of the telescope, they are telling me that they are not happy. That is why I am asking you for your opinion on the specifics.

Now, let me ask you—I am getting ready to go; this is one of those days when four committee meetings are going on at the same time, and the one that I still have not gotten to is the Armed Services Committee, and I am going to go and talk to Secretary Rumsfeld, who I think is doing an excellent job, and I said that well before September 11, by the way, in the committee—but I note in the budget that there is a $10 billion item that is un-itemized for defense. And it struck me that that is a circumvention of the constitutional balance of checks and balances where, under the Constitution, Congress appropriates the money—the Administration requests, the Congress appropriates—and it struck me as a blank check request.

Can you comment on that, please?

Mr. DANIELS. Yes, sir. It is a difficult question. The issue here that Secretary Rumsfeld and I have wrestled with is how can the flexibility of the President to deal with events that we cannot foresee or to take actions and decisions that he has not yet made be enhanced, while respecting the role of the Congress.

The idea here would be that there would be an appropriation on a contingent or an emergency basis, subject to the President's declaration that certain conditions had been met that would trigger, and only that could trigger the spending of the money. This would be much akin to what was done in the emergency bill of last fall.

But your concern is well-placed, and there ought to be clear definitions and restrictions before that money could be spent. But the idea is to enable the President as Commander-in-Chief to move very quickly if he decides circumstances warrant.

Senator NELSON. Well, I suspect that that is going to be an item that is not going to be particularly well-received here because of the traditional congressional process of supplemental appropriations bills, emergency appropriations, specific items that need to be enacted. Clearly after September 11, the Congress gave the President the authority to spend the funds to wage the war. That is an appropriate legislative function under the Constitution and so too, I think, is the appropriation of the money to prosecute that war.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

Welcome, Director Daniels.

Mr. Chairman, in thinking about the hearing today and the budget situation that we have in front of us, I was thinking a lot about Sunday's Superbowl. Before the game, the pundits said that the St. Louis Rams would beat the New England Patriots by 14 points, but the Patriots defied the conventional wisdom and beat the Rams with a last-minute field goal.

The lesson that we learned is that predictions do not always come true, and this is certainly the case with the budget proposals that were before us last year and the challenges this year.

Director Daniels, as I know you remember, last year, you said that we would use all of the Social Security surplus from 2002 to 2011 to pay down debt. You also indicated that we would have a $1.4 trillion contingency fund to pay for all of our future needs. You also projected that the 2002 budget surplus would be $231 billion. Finally, you stated that we would pay down the maximum debt possible over the next 10 years. I am sure you feel like those who predicted a St. Louis Rams victory in Sunday's Superbowl.

Seriously, though, I am very concerned as we move forward, and I know that we all are, but despite the failure of many of last year's promises to come true, what I am most concerned about is the Administration continuing to move forward and advocate for very large tax breaks, supply side economics targeted to the wealthiest Americans, that are clearly now going to be paid for by using Social Security and Medicare Trust Funds.

Director Daniels, that is why many of us talk about Enron. It is not that there is a direct connection, a legal connection or a factual connection between both of these situations, but because Enron is a good analogy for what is happening. We have those at the top, the wealthiest employees, the folks who were at the very top, making decisions and being able to receive large amounts of money, leaving the middle-class workers paying for it out of their 401(k)'s, their retirement systems. And I would argue that that analogy is in fact what is happening here if we continue on the track without any regard to fiscal responsibility or the long-term solvency of Social Security and Medicare.

So I would ask you this. For the baby boomers who are going to be retiring very soon, in the first round, in 2008, 2009, do you think that they are better off today than they were a year ago?

Mr. DANIELS. I do. Let me explain why by responding to some of the interesting points that you made. I will say that in general, they are better off the more of their own money they are able to control now and in their retirement, and that is the direction of both tax relief and the proposal for long-term reform of our retirement programs.

I think they will be much better off when they have more autonomy and are less dependent on the whims and winds of politics in Washington.

Predictions are a risky business. Last year was described in The Washington Post as "a nightmare for economists." They went on to point out that everybody missed the recession, both its coming on and its depth. Fifty-one of the 54 Wall Street Journal panelists missed it; CBO missed it; the Administration missed it. That alone took us well below the level of the Social Security surplus. There is nobody to be blamed for that; that is what happens in a recession.

I freely confess that with all of our acumen and our forecasting models, we did not know that September 11 was coming, and that has made a very profound difference not only on this year's budget as we have illustrated, but in terms of what the President believes are the ongoing needs in defense to make sure that the first responsibility of Government, the safety of the American people, is met. That is a responsibility that he places even above surpluses and paying down our debt, as important as that is.

Last, I would say be of good cheer, because we could be in far worse shape than we are. This is the smallest recession, this recession deficit, that we have seen, and the previous recessions did not have a war laid on top of them.

I will give you a quick look at that. This chart shows this year, which is the trough; next year—and this again assumes that we pass a stimulus package, which we may not, but we certainly hope we do—back in balance as early as the year after next.

I could easily be back here next year with—let us just remember how unique last year's number was. These are the 10-year surplus projections for what they are worth. In the few years that we have told ourselves we somehow had the ability to forecast out this far—in fact, I submit to you we do not, and we ought to quit kidding ourselves—but here are the numbers. If we had taken a 1-year time out from 10-year numbers, we would be looking at the biggest one we had ever seen. So next year, that number could go back up. It is driven so completely by economic assumptions that if we can get growth going again, and if there is the prospect of somewhat higher growth over the time period, I do not doubt that we will be back into surplus sooner, and we will be back paying down debt, as you and we would like to do.

Senator STABENOW. Listening to you makes me wonder, though, as we talk about projections and the fact that they are in fact just projections, and many of us on this committee argued that in the committee, on the floor, over and over again last year as we were moving ahead, that we should not lock ourselves into a 10-year course of action on any front, whether it be spending, whether it be tax policy, because we are spending dollars that we do not know if they will materialize. But listening to you makes me wonder why in fact you have been opposed to the notion of an economic trigger that Senator Snowe and I and Senator Bayh and others have put forward to focus on fiscal responsibility.

The notion of an economic trigger is to simply say that we are going to keep a focus on balancing the budget and not spending Social Security and Medicare, and that if we are moving too far through tax policy or spending policy into that, we want an automatic way that forces us to come back and address that in a conscious way.

I also believe that that would send a message of fiscal responsibility to those on Wall Street and others who are looking at long-term interest rates. And I am very surprised that in talking about how unpredictable the long-term projections are, you would not want to in fact then put some more predictability around it, or at least some mechanisms for that in terms of the budget triggers.

Mr. DANIELS. First of all, Senator, I will just point out that the Government under any circumstance, whether tax relief remains in place or is taken away by this or some future Congress, revenues are going to grow very, very fast—55 percent over this time period. We will have all sorts of additional money available for all these purposes.

The yellow bars here simply indicate the small amounts by which last year's tax relief will diminish what will remain an historically very high take—19 cents of every dollar Americans create in this economy. There will be lots and lots of chances. If the Congress should come to the conclusion that it must have this money and that it must not allow this relief to take place, the vast majority of it will not happen for quite some time. That took into account, one could say, the uncertainty of outyear projections.

So it is not right to say, as some people kind of thoughtlessly do, that the money is gone; it is not at all.

Senator STABENOW. Well, Mr. Daniels, if I may——

Chairman CONRAD. Senator, if I could just interrupt, because you have gone over your time. Maybe we could go to Senator Corzine and then get into the second round.

Senator STABENOW. Absolutely.

Chairman CONRAD. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman, and welcome, Director Daniels.

I want to follow on with some of the questions that I think have come up with regard to Social Security. First of all, in response to Senator Stabenow's question about are we better off, do we really believe that folks are better off with regard to the solvency of Social Security today than we were a year ago as we sat here? Are we as likely to be able to provide the benefits that are promised today as we were a year ago, given the track we were on with regard to paying down the debt and building up the surpluses in the Social Security Trust Fund?

Mr. DANIELS. I think we are in exactly the same position, really. I think there will not be a material difference until we reform and restructure Social Security. I know where your question heads. If, as still may be the case—I do not know, and you do not know—if we are able to pay down lots of debt over the next stretch of time until Social Security turns cash-negative, that would be a good thing, but it will not solve our problems at all, and we will not be able to re-borrow our way around those problems. We are going to have to restructure the system in a way that makes it more self-sustaining.

Senator CORZINE. If you believe that——

Mr. DANIELS. I thought the Senator's question—and I probably did not accurately or fully answer it—was an interesting one. The basic reason I would answer in general that we are better off, Senator, is that I believe we are now more aware, tragically, of the dangers to our country, and we are in the process of making Americans much safer, and that is the most fundamental way in which we can be better off now than a year ago.

Senator CORZINE. I think anyone who would look at the actuarial projections would say that we have shortened the life of the ability of the trust fund to provide the benefits without changing other conditions, given that we have not been paying down the debt.

I know the Administration is very much for moving toward a privatization of some element of Social Security. Have you allowed in your budget projections any allotment for the transition costs or expectations of what that would cost to move Social Security to the reform view, or at least as you would label it, a reform perspective on what Social Security should be?

Mr. DANIELS. No, sir, not at this time. As you know, this is probably going to be a long national conversation. The commission has spread a menu of options, and the President hopes to move that dialog ahead, but we do not have agreement yet on a plan, so we cannot cost or even estimate what the transition might cost.

Senator CORZINE. Do you accept the estimates that the transition cost might approach $1 trillion?

Mr. DANIELS. I do not know. Under certain kinds of reforms, that number would be very realistic, but I do not know what kind of reform we may finally be dealing with.

Senator CORZINE. Are you or the Administration willing to publicly reject some of the cuts in benefits that were proposed by the President's commission?

Mr. DANIELS. Well, I am not sure which ones you are talking about. The President made very, very clear——

Senator CORZINE. There was a very specific recommendation with regard to COLA adjustments that would cut benefits really quite substantially—estimates from as low as 24 percent for workers retiring in 2040 and 43 percent for those in later years—because of an entirely different formulation on how you increase payouts for benefits.

Mr. DANIELS. Well, the President's first principle when he started the commission was that all current promises, all benefits have to be paid, and I am sure that will be a part of any reform that ever wins his approval.

Senator CORZINE. So you are not yet in a position where you could say, though, that we would not be cutting benefits for future beneficiaries of Social Security.

Mr. DANIELS. I do not see this being the case. You know, the whole goal here, the principal objective, is to try to create a better deal for future beneficiaries who right now are trapped in a really losing game with very, very low returns, perhaps even negative under some scenarios, and the objective is to create a retirement system that gives them a fairer return when their retirement comes.

Senator CORZINE. Well, again, if one were to move to that system, most of the analyses that I have seen indicate that it is going to require huge transition costs which are going to exacerbate the kinds of problems that we are already talking about with forward looks at our budget position as we go forward.

Do you buy the arguments that we are using Social Security payroll taxes to fund some of the other activities, particularly the tax cuts that we are implementing over the next 10 years?

Mr. DANIELS. I would remind the committee that we always use surplus revenues for some purpose, and that in this wartime, we will be using some of them to defend Americans as opposed to paying down debt, as we would rather be doing, but the dollars are used in any event.

By the way, I would just point out parenthetically, because sometimes we overlook this, that almost half of the surpluses that we credit to Social Security—about $170-odd billion this year—is not payroll taxes. It is simply the interest we credit based on the sized of the fund at the time. So just for semantic purposes, we should be careful. But the general point that you make is accurate. We always have a choice to make about what to do with any excess funds there, and like you, we would like to be using it to reduce debt again as soon as circumstances permit.

Senator CORZINE. Director, I do not think anyone is going to argue about homeland defense or prosecution of the war on terrorism as a need for using the unified budget revenues, but I think there is a legitimate reason to have a debate about whether payroll taxes, which really fall most heavily on those at the lower end of our income scale, a more regressive tax to pay for tax cuts, is a questionable principle that we need to have debated. Whether one accepts that or not, it certainly is a fact that those funds in some way are sourcing or cutting back those revenues that would otherwise have been collected.

So in some ways, we are funding these tax cuts, in one analysis, off the backs of payroll taxes.

Chairman CONRAD. Senator Domenici.

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

I might say, Senator Smith, that if you would like to stay on in my stead, I understand the chairman may go around again, and I will try to keep my questions very short.

First, let me ask you if you have a chart that shows the amount or percentage of tax take that the United States receives from the taxpayers over a sustained period of history? Did you bring that along?

Mr. DANIELS. It so happens I do, Senator.

Senator DOMENICI. Fritz, we did not talk before.

Senator HOLLINGS. You should have.

Mr. DANIELS. Like the ad used to say, I do not leave home without it.

I think it is worthy of keeping in mind that even after tax relief, Americans are paying historically very, very high amounts in taxes, well above the post-war average, which in previous time would trigger, under President Kennedy, President Reagan and others, reductions down below that about 18 percent average level. And even after tax relief, we are going to continue well above it.

So I do believe that it is important to note that, absent tax relief, we would have been at all-time record levels of taxation, and that is probably not good for the economy, let alone fair to the American people.

Senator DOMENICI. Let us just make it very simple. You have a chart that shows that. The tax take remains historically high, you say, and you show it with that chart.

Now, there are probably some Americans who listen to the debate and discussion about are taxes too high, are taxes too low; did the 10-year tax cut which was implemented over time, most of which came in the last 3 or 4 years, but would come in over a period of time, giving them their taxes back—the question is being raised whether that was a mistake, whether it was too much. And I guess I would just like to establish once and for all, from my standpoint and perhaps from the record, that since there is no magic as to what level of taxation should be imposed on the American people—and by that, I mean nobody knows what the best level is, but I think it would be fair to say that everybody assumes from the standpoint of economic growth and prosperity the lowest level is the best level—prosperity with low levels of taxation is probably better for sustained economic growth than high taxes. In fact, the European countries are kind of struggling as to how to get out of the box they got themselves in because they went in the other direction.

Now, having said that, in this chart, have you plugged in the tax cuts that will occur over the next decade as passed by both Houses of Congress and signed by the President? They are in there, are they not?

Mr. DANIELS. Yes, sir. They are on the blue line, and they are fully taken into account on the blue line.

Senator DOMENICI. OK. Could you tell us, then—just give us 3 or 4 years during that tax reduction cycle, and tell us what the percent of GDP is represented by the tax take from the American people and American business.

Mr. DANIELS. Yes. It is right around 19 percent consistently across the time period. It is right around a point to a point and a half above the post-war average.

Senator DOMENICI. OK. And what does one and a half points mean in dollars?

Mr. DANIELS. Well, in today's economy, which is $10.2 or $10.3 trillion, a point and a half would be $150 billion, I guess.

Senator DOMENICI. All right. We had a situation on the floor of the Senate post-September 11 where the Majority Leader brought to the floor three amendments that he wanted to take up in 1 week. They were an agricultural spending bill—you are aware of that——

Mr. DANIELS. I recall.

Senator DOMENICI [continuing]. There was a railroad retirement bill——

Mr. DANIELS. I recall that very well.

Senator DOMENICI [continuing]. And there was a stimulus package that Senator Byrd wanted to add about $15 billion to the President's request. Do you remember that?

Mr. DANIELS. Yes, sir.

Senator DOMENICI. My arithmetic says that in pushing for those and offering them, that was a little bit over $100 billion that, under these changes, was going to affect the surplus, if any; right?

Mr. DANIELS. Well, it would actually be more than that, conceivably, because if Senator Byrd's amendment had passed, it would have had continuing effects over the years. But just adding them up on the face of the bills, your number would be about right.

Senator DOMENICI. OK. Now, many of the same Senators who voted for that are now suggesting that the President in his spending of money post-September 11 is taking money from the Medicare and Social Security Trust Funds. I ask you is there any other place that this $100 billion could have come from at that point in the fiscal condition of America?

Mr. DANIELS. Well, sir, it would have just the same effect of using funds for other purposes that could have theoretically been used or otherwise been used to pay down some debt.

Senator DOMENICI. So I make those two points—one, that Americans are not undertaxed even when the 10-year tax plan is implemented, and it is a long way from getting there; and for those who want to change it, they have plenty of years to change it, because the biggest piece of it will not go into effect until the seventh, eighth, ninth, and maybe even tenth years of that tax plan. And second, when you find yourself in a war and in a recession, it is not unusual for you to have to use any surplus that had theretofore accumulated. That is what is happening to America right now. We had a surplus; we have a war that costs a huge amount of money; and if that is not enough, we have a recession on top of it that lost huge amounts of money.

Is that a fair statement?

Mr. DANIELS. It is perfectly accurate.

Senator DOMENICI. I have one last one, because people are somewhat confused as to which tax cut some people are talking about when they say it was a tax cut that this President imposed on the American people and on our economy, and it got rid of our surplus; it was the tax cut.

Well, first, I would like to describe this just briefly in two ways. There is a tax cut that took effect for the year 2002, and as I understand it, the surplus greatly diminished during a recession and a war at that point in time. I have a small chart—this was not made bigger, so I will just try to hold it up—if it gets on television OK, if it does not, I am pretty good at explaining.

This red, which has a 72 up alongside of it, is 72 percent; and this green is 12 percent; the gray is 14 percent. What our experts, including the Congressional Budget Office, say this is is a pictorial of what happened to the surplus. Seventy-two percent of it went because we had a recession, and when you had a recession, huge amounts of money that would have come into the Treasury did not come into the Treasury, the biggest one being that we had all expected the economy to grow at more than 3.5 percent, and that yields a very steady, strong, powerful revenue stream. As a matter of fact, that did not occur. It came down and at parts of that year was hovering negative rather than positive.

So as any economist would have expected and just said as a matter of B follows A, this would be very big, and it is. That is where the surplus reduction, the surplus diminution, the disappearance of—that is the principal one.

And lo and behold, the next one is green, 12, and that represents the tax cut, that is, the portion of the tax cut that was carried out for that particular year. The number is $38 billion; the percentage is 12.

The next one is discretionary spending that was spent that was not contemplated to be spending but had to be spent because we had the war.

Add them up, and there is the reduction in the surplus. It is nothing mysterious. It is not anything that is difficult to explain. It is something that it is very difficult to lay blame to anyone—an administration or a previous administration.

And lo and behold, the American people after hearing all of us are coming to the conclusion in large droves that, number one, the recession was not caused by either Administration or any particular leadership. That is what Americans believe. Isn't it interesting? They are more right than the partisans who choose to lay blame someplace else. That is exactly right—nobody caused it. It was a very long prosperous growth period, and it stopped for a while.

I think we can be fortunate—and I will ask your views—that this recession seems not to have been one that is going to go deep nor long. Qualify your answer however you wish, but is that a fair assessment of the recession as you see it now?

Mr. DANIELS. I honestly do not know, Senator. There are obviously some promising signs, but the President's point of view as we have discussed is not enough to rest on our oars, and therefore, let us try to do some more to bring the economy back quickly.

Your analysis about the change in the surplus is exactly right. You know, revenues fell so far below what had been hoped for, they actually would have fallen year on year. Pretend there had never beenany tax relief—revenues would still have fallen. Pretend there had never been any tax relief—we would have still been well below—way below—the level of the Social Security surplus. And it is not anybody's fault. I think the President would agree with you that this is not about blame. Recessions do this—let alone recessions compounded by war.

The question is how quickly can we come out of it, and what common sense steps can we take to make that happen.

Senator DOMENICI. I want to close by asking your permission to make a statement a part of the record. It is from Richard J. Santos, National Commander of The American Legion, and it is a comment with reference to the President's budget on veterans' affairs.

Chairman CONRAD. Certainly.

[The prepared statement of Mr. Santos follows:]

PREPARED STATEMENT OF RICHARD J. SANTOS, NATIONAL COMMANDERS, THE AMERICAN LEGION

Mr. Chairman and Members of the Budget Committee:

The American Legion welcomes the opportunity to present its views on the fiscal year 2003 Budget Resolution. As you and your colleagues consider the President's recent budget request, I share the views of the Nation's largest wartime veterans' service organization.

The American Legion's reputation as an advocate for maintaining a strong national defense is well documented, dating back to its very beginning in 1919 in Paris, France. As veterans of the *War to End All Wars*, The American Legion founders established an organization:

- To uphold and defend the Constitution of the United States of America;
- To maintain law and order:
- To foster and perpetuate a one-hundred percent Americanism;
- To preserve the memories and incidents of our associations in the Great Wars;
- To inculcate a sense of individual obligation to the community, State, and Nation;
- To combat autocracy of both the classes and the masses;
- To make right the master of might;
- To promote peace and good will on earth;
- To safeguard and transmit to posterity the principles of justice, freedom and democracy;
- To consecrate and sanctify our comradeship by our devotion to mutual helpfulness.

The only common bond of all Legionnaires is honorable military service during a period of armed conflict. Legionnaires are men and women that belong to an organization based upon comradeship. This group of veterans is devoted to fair and equitable treatment of their fellow veterans, especially the service-connected disabled. Another group of veterans honored by The American Legion is those fallen comrades that are killed in action (KIA), missing in action (MIA), or those held as prisoner of war (POW). These service members often leave spouses and children behind. For those who have paid the ultimate sacrifice for freedom, The American Legion will honor their service by making sure this Nation fulfills its promises to their survivors. For those listed as MIA or POW, The American Legion will continue to demand the fullest possible accounting of each and every comrade.

NATIONAL SECURITY

The deep-rooted interest of The American Legion in the security of the Nation was born in the hearts and minds of its founders and sustained by its current membership. The bitter experiences of seeing comrades wounded or killed through lack of proper training crystallized the determination of Legionnaires to fight for a strong, competent defense establishment capable of protecting the sovereignty of the United States. The tragic events of World War I, largely precipitated by unprepared military, were still vivid in the minds of combat veterans that founded The American Legion. After 22 years of repeated warnings by The American Legion, Pearl Harbor dramatically illustrated the cost of failed vigilance and complacency.

For over 83 years, The American Legion's drumbeat on defense issues has remained constant. With the evolution of space age technology and scientific advancement of conventional and nuclear weapons, The American Legion continues to insist on a well-equipped, fully manned, and a properly trained fighting force to deter aggressors. The events surrounding September 11, 2001 publicly exposed a soft underbelly of America to acts of terrorism, especially the vulnerability to nuclear, biological, and chemical (NBC) warfare.

America's armed forces must be well manned and equipped. not to pursue war, but to preserve the hard-earned peace. The American Legion is fully aware of what can happen when diplomacy and deterrence fail. Many military experts believe that the current national security is based on budgetary concerns rather than real threat levels to America and its allies. As the world's remaining superpower, America's armed forces need to be more fully structured, equipped, and budgeted.

Defense budget, military manpower, and force structure are currently improving over the fiscal year 2001 levels. The current operational tempo of active-duty and Reserve and Guard forces remains extremely high and very demanding. The American Legion recommends:

- Active-duty personnel level should not be less than 1.6 million.
- The Army must maintain 12 fully manned. equipped, and trained combat divisions.

- The Navy must maintain 12 aircraft carrier battle groups and a viable strategic transport capability.
- The Air Force must maintain, at a minimum, 15 fighter wings, a strategic bombing capability, its Intercontinental Ballistic Missile capability and a global strategic transport capability.
- Deployment of a national missile defense system.
- The defense budget should equal 3–4 percent of the Gross Domestic Product.

The current active-duty personnel level is approximately 1.37 million. Military leaders are making up the difference by increasing the operations tempo and by over-utilizing the Reserve components. Currently, American military personnel are deployed to over 140 countries worldwide. Overseas deployments have increased well over 300 percent in the past decade. Many of these personnel continue to come from the Reserve and Guard components.

Cuts in force structure cannot be rapidly reconstituted without the costly expenditures of time, money, and human lives. Modernization of weapon systems is vital to properly equipping the armed forces, but are totally ineffective without adequate personnel to effectively operate the state-of-the-arts weaponry. The American Legion strongly recommends adequate funding for modernization of the services. America is losing its technological edge. No American soldier, sailor, airman, or Marine should be ordered into battle with obsolete weapons, supplies, and equipment. America stands to lose its service members on the battlefield and during training exercises due to aging equipment. The current practice of trading off force structures and active-duty personnel levels to recoup modernization resources must be discontinued.

The American Legion recommends restoring the force structure to meet the threat level and to increase active-duty personnel levels. Ensuring readiness also requires retaining the peacetime Selective Service System to register young men for possible military service in case of a national emergency. Military history repeatedly demonstrates that it is far better to err on the side of preserving robust forces to protect America's interest than to suffer the consequences of ill preparedness. America needs a more realistic strategy with an appropriate force structure, weaponry, equipment, and active-duty personnel level to achieve its objectives.

A major national security concern is the enhancement of the quality-of-life issues for service members, Reservists, National Guard, military retirees, and their families. During the First Session, President Bush and Congress made marked improvements in an array of quality-of-life issues for military personnel and their families. These efforts are visual enhancements that must be sustained. The cost of freedom is on going, from generation to generation.

The President and Congress addressed improvements to the TRICARE system to meet the health care needs of the military beneficiaries; enhanced the Montgomery GI Bill educational benefits; and homelessness throughout the veterans community. For these actions, The American Legion applauds your strong leadership, dedication, and commitment. However, one issue still remains unresolved: the issue of concurrent receipt of full military retirement pay and VA disability compensation without the current dollar-for-dollar offset. The issue of concurrent receipt appeared in the fiscal year 2002 budget resolution and the fiscal year 2002 defense authorization act. Every day, new severely disabled military retirees are joining the ranks of American heroes being required, by law, to forfeit military retirement pay.

Recently, 14 soldiers and 2 airmen were awarded Purple Hearts from the War on Terrorism. These newest American heroes would be the latest victims of this injustice should their war wounds result in debilitating medical conditions. During the State of the Union Address, one such future recipient, SFC Ronnie Raikes, was sitting next to the First Lady. Concurrent receipt legislation in both chambers (S. 170 and H.R. 303) has overwhelming support by your colleagues. With the President's proposed $48 billion increase in defense spending, The American Legion believes now is the time to correct this terrible injustice. Enactment of corrective legislative and fully funding concurrent receipt are actions to properly reward heroism and courage under fire.

If America is to continue as the world's remaining superpower, it must operate from a position of strength. This strength can only be sustained through meaningful leadership and adequate funding of the armed forces.

VETERANS' HEALTH CARE

The American Legion believes that the primary mission of the Department of Veterans Affairs (VA) is to meet the health care needs of America's veterans. The American Legion believes that the VA should continue to receive appropriate funding in order to maximize its ability to provide world-class health care to the large number of aging veterans, while still maintaining services to a younger cohort of veterans who are using VA for the first time. The American Legion greatly appreciates the actions of all Members of Congress regarding the increase in VA Medical Care funding for fiscal year 2002. Now, please focus your attention to the increases in fiscal year 2003.

Just like the Medicare and Medicaid programs, the VA health care budget requires an annual increase to maintain its existing service level and to fund new mandates. For years, VA managers were asked to do more with less. The recent funding increase now allows the Veterans Health Administration (VHA) to catch up with the growing demands placed upon the system and repair some of the problems related to long patient waiting times and limitations on access to care.

The American Legion felt that the President's budget request last year failed to accurately reflect VA's fiscal year 2002 health care funding needs. VA's projections misrepresented the actual number of veterans seeking care. It appears that the President's budget request was based on a much lower number of patients projection (less than 3 percent) than the actual number of users (closer to 11 percent). Fortunately, Congress added over $300 million to the President's original request; however, VHA is now faced with dealing with an inadequate fiscal year 2002 budget. The American Legion believes that close to 5 million veterans will seek care in VHA medical facilities in fiscal year 2003. Last year, The American Legion requested $21.6 billion in fiscal year 2002; however, this year we recommend $23.1 billion for VA medical care.

Many factors are driving more veterans to use VHA as their primary health care provider:

- Many Medicare+Choice health maintenance organizations (HMOs) withdrew from the program;
- Many HMOs collapsed;
- VHA has opened community based outpatient clinics;
- Double-digit increase in health care premiums;
- The dramatic fluctuations in the national economy make VHA a more cost-effective option for veterans; and
- VHA's reputation for quality of care and patient safety is attracting new patients.

Where comparable data exist, VHA continues to outperform the private sector in all indicators in health promotion and disease prevention. The American Legion adamantly believes VHA is the best health care investment of tax dollars. The average cost per patient treated within VHA is unmatched by any other major health care delivery system, especially with comparable quality of care.

Mr. Chairman and Members of the Committee, the reason VHA medical care continues to increase annually is not because of uncontrollable cost increases nor poor cost estimations, but rather because thousands of veterans are voting with their feet. More and more veterans are choosing to use their earned benefit—access to VHA. However, enrollment in VHA is limited to existing discretionary appropriations. The American Legion urges Congress to evaluate several options that would assure every veteran that wants to enroll in VHA can enjoy that earned benefit. The key factor driving the increases in medical care funding requirements has not been uncontrolled cost increases, nor has it been poor cost estimation processes—it has been the unexpected and dramatic increase in demand for care from the VA system.

The overall guiding principle for VA must be improved services to veterans, their dependents, and survivors. This will require improving access and timeliness of veterans' health care; increasing quality and timeliness in the benefit claims process; and enhancing access to national and State cemeteries. Specific American Legion objectives for Congress include:

- Sound VHA funding for long-term strategic planning and program performance measurement,
- Additional revenue for staff and construction,
- Medicare subvention,
- Pilot programs for certain dependents of eligible veterans,
- VA and DoD sharing,
- Reduce the claims backlog,
- Repeal bar to service-connection for tobacco-related illnesses,
- Increase the rate of beneficiary travel reimbursement, and
- Allow all third-party reimbursements collected by VA to supplement, rather than offset, the annual Federal discretionary appropriations.

The American Legion created the *GI Bill of Health* as a blueprint for meeting the current and future health care requirements of the Nation's veterans and for supplementing VA's annual health care appropriation. The *GI Bill of Health*, once fully implemented, would expand VHA's patient base and increase its non-appropriated funding through new revenue sources.

As VHA continues to re-invent itself, change is not a defining event, but rather a series of small steps. Despite its recent successes, VHA still faces numerous future challenges.

The American Legion believes VHA's long-term future must be clearly defined to be responsive to those who have "borne the battle." All individuals, who enter military service, should be assured that there is a health care system dedicated to serving their needs upon leaving the military. That concept is especially important to disabled veterans and to retired service members. The *GI Bill of Health* would ensure that all honorably discharged veterans would be eligible for VA health care, as they will fall into one of the core entitlement categories and into a health insurance or buy-in category. A unique feature of the *GI Bill of Health* is that it will also permit certain dependents of veterans to enroll in the VA health care system.

The American Legion commends VA for the changes made within VHA over the past few years. These changes include eligibility reform, enrollment, the reorganization of the 172 medical centers into 22 integrated operating units, the elimination of certain fiscal inefficiencies, and the expansion of community based outpatient clinics. In some cases, The American Legion believes VA has gone too far in attempting to improve fiscal efficiency. Veterans should not have to increase their travel time for the benefit of the Department. Rather, VHA needs to improve its cooperation with other Federal, State, and private health care providers to improve the quality and timeliness of care for veterans and their families. The American Legion encourages VHA to continue to provide health care that is the highest quality to all veterans at the most reasonable cost.

Two additional significant steps required to re-engineer VHA are Medicare subvention and permitting certain dependents of veterans to utilize the system.

Unlike in the private sector, Medicare-eligible veterans cannot use their Medicare benefits in a VHA facility for treatment of nonservice-connected conditions. When Medicare-eligible veterans receive health care treatment for any medical condition in the private sector, the Federal Government reimburses the health care provider for a portion of that service. When Medicare-eligible veterans receive health care treatment for the same medical conditions (nonservice-connected) within VHA, the Federal Government will not reimburse VHA for any portion of that service. This equates to a restriction on a veteran's right to access health care of his or her choice and using his or her Medicare benefit. The American Legion believes that Medicare subvention will result in more accessible, quality health care for all Medicare-eligible veterans. Furthermore, Medicare subvention should greatly reduce incidents of fraud, waste, and abuse in billing because it will occur between two Federal agencies with congressional oversight. Today's fiscal realities requires VHA to seek other revenue streams to supplement the growing demand for service and not simply rely on saving more dollars to serve more veterans. The American Legion strongly recommends allowing Medicare subvention for Priority Group 7 Medicare-eligible veterans enrolled in VHA.

Allowing certain veterans' dependents access to health care within VHA will also help develop new revenue streams and will ultimately improve recruitment and retention within the armed forces. Service members need to know that their dependents have access to quality health care while serving on active duty. The American Legion believes that VHA can and should play a larger role in the provision of this care to active duty service members. Additionally, when service members leave active duty, this health care coverage should continue. VHA has the capacity and the capability to play a much larger role in the provision of health care to the beneficiaries of DoD health care system.

VHA has six strategic goals through the year 2006:

- Put quality first.
- Provide easy access to medical knowledge, expertise and care.
- Enhance, preserve and restore patient function.
- Exceed customers' expectations.
- Save more dollars to serve more veterans.
- Build healthy communities.

Unfortunately, nowhere in the list of VHA priorities are the goals of Medicare-subvention, the treatment of veterans' dependents, expanding the non-appropriated funding revenue base, and greater cooperation with the private sector and with DoD health care system.

VETERANS' BENEFITS

Given the number of veterans and other claimants who file claims each year and with an annual expenditure of over $25 billion in compensation and pension payments, it is imperative that Congress maintain strong oversight of the operations of Veterans Benefit Administration's (VBA's) Compensation and Pension Service.

Over the last several years, the backlog of pending claims and appeals has increased dramatically and now exceeds over 660,000 cases. It routinely takes six months to a year or more to process disability compensation claims. In addition, annually, some 60,000 to 70,000 new appeals are initiated. After a wait of over two years for an appeal to reach the Board of Veterans Appeals (BVA or the Board), more than 20 percent will be allowed and more than 22 percent will be sent back to the regional office for further required development and readjudication. Remanded cases may be pending for another year or two, in the regional office before returning to the Board. Sometimes, cases are remanded two and three times because the specified corrective action had not been completed, which adds several more years to the appeal.

Unfortunately, there is a pattern of recurring issues, which continue to have a direct and adverse effect on the quality and timeliness of regional office claims adjudication. They relate to budget, staffing, training, quality assurance, accountability, and attitude. These findings confirm our long-held view that quality must be VBA's highest priority. Without guaranteed quality, thousands of claims will continue to process unnecessarily through the system; much of VBA's valuable financial and personnel resources will be wasted; and veterans will not receive the benefits and services they are entitled to and that Congress intended they should have.

The American Legion believes VBA is committed to bringing about much needed change to the claims adjudication system with the overall goal of providing quality, timely service to veterans and its other stakeholders. In recent years, VBA's strategic plans have made many promises and we have, in fact, seen the implementation of a variety of programmatic and procedural changes. However, it is obvious that progress toward major improvements in service continues to be slow and that much remains to be done. The overall quality of regional office decision making remains problematic.

Secretary Principi has identified many problems and is working diligently to find solutions that will provide improved service to veterans and their families. There are a spectrum of ongoing and planned initiatives, such as the Pre-Discharge Examinations, Personnel Information Exchange System (PIES), Electronic Burial Claims, Virtual VBA, Decision Review Officer (DRO) Program, and personal hearing teleconferencing, just to name a few. In addition, VBA has begun implementing the recent recommendations of the Secretary's Claims Processing Task Force focusing on improving the operating efficiency of the process and procedures by which claims are adjudicated. These involve special initiatives to better manage the claims and appeals. There will be an emphasis on better training for the many newly hired adjudicators. Performance standards are being implemented that provide for personal and organization accountability. VBA is continuing the development of its information technology program.

While we support these much-needed changes, we are concerned that they only indirectly address the core problem of continued poor quality decision making. Without a vigorous, comprehensive quality assurance program, thousands of claims will continue to process needlessly through the regional offices, the Board of Veterans Appeals, and the courts wasting time, effort and taxpayers' money. Veterans have a right to a fair, proper, and timely decision. They should not have to endure financial hardship and delay before receiving the benefits to which they are entitled by law.

The workload and budgetary requirements of National Cemetery Administration (NCA) will continue to grow over the next 15–20 years. The death rate of World War II veterans will peak in 2008, but the annual death rate of veterans will not return to 1995 levels under 2020. The death rates of Korean and Vietnam Era veterans will greatly accelerate thereafter. The American Legion continues to fully support the further development of the State Cemetery Grants Program.

The Veterans Millennium Health Care and Benefits Act (Public Law 106–117) requires VA to provide long-term nursing care to veterans rated 70 percent disabled or greater. The new law also requires VA to provide long-term nursing care to all other veterans for service-connected disabilities and to those willing to make a copayment to offset the cost of care. Further, it requires VA to provide veterans greater access to alternative community-based long-term care programs. These long-term care provisions will place greater demand on VA and on the State Veterans Home Program for years to come.

The American Legion believes that it makes economic sense for VA to look to States governments to help fully implement the provisions of PL 106–117. VA spends on average $225 per day to care for each of their nursing care patients and pays private-sector contract facilities an average per diem of $149 per contract veteran. The national average daily cost of care for a State Veterans Home nursing care resident is about $140. VA reimburses State Veterans Homes a per diem of $40 per nursing care resident. Over the long term, VA saves millions of dollars through the State Veterans Home Program.

The American Legion supports the State Veterans Home Program and believes the Federal Government must provide sufficient construction funding to allow for the expected increase in long-term care veteran patients.

On September 11, 2001, I was about to present testimony before a Joint Session of the Veterans' Affairs Committees, when we were directed to evacuate the Cannon House Office Building. Like Americans around the world, I was shocked by the barbaric, terrorist actions taken against innocent airline passengers, those in the World Trade Towers, and those in the Pentagon. My heart swelled with pride as fearless rescue workers, fellow service members, and private citizens rushed to assist the victims, only to experience the heartache as the Twin Towers collapsed turning heroes into victims in a matter of seconds. At that specific moment, the importance of that testimony paled in comparison. The American Legion's efforts, like the rest of America, shifted to what we do best—helping at the community, State, and national level.

SUMMARY

Since I was unable to formally present my testimony, I did submit The American Legion's recommendations for the VA budget for fiscal year 2003 for the record. Today, it is important that I share that information to this committee:

Program	P.L. 106-377	P.L. 107-73	Legion's FY 2003 Request
Medicare	$20.0 billion	$21.3 billion	$23.1 billion
Medical and Prosthestic Research	$350 million	$371 million	$420 million
Construction	xl	xl	xl
Major	$66 million	$183 million	$310 million
Minor	$170 million	$211 million	$219 million
State Veterans' Home	$100 million	$100 million	$110 million
State Veterans' Cemeteries	$25 million	$25 million	$30 million
NCA	$110 million	$121 million	$140 million
General Administration	$1 billion	$1.2 billion	$1.3 billion

The American Legion believes that the true character of any democracy is best reflected in the way it treats its veterans of the armed forces—the true preservers and defenders of liberty.

Mr. Chairman and Members of the Committee, that concludes my written statement.

Senator DOMENICI. And Senator, I will not read this, but I would ask that it go in the record. This is your statement with reference to what the war and the recession did to the surplus and what we had to do——

Chairman CONRAD. It is an excellent statement. I am happy to put it in the record. We can spread it all across the record. [Laughter.]

Senator DOMENICI. As a matter of fact, I believe that all Republicans would vote yes, since it says "our concern for protecting the integrity of the Social Security and Medicare Trust Funds remains but must be achieved by returning to a policy of fiscal discipline over the long term."

In any event, thank you for the time today and for the excellent hearing. I am not going to stay any longer. I do not know what your plans are.

Chairman CONRAD. I have a lot of plans after what I have heard.

Senator DOMENICI. I will stay, then.

Senator HOLLINGS. Senator Domenici, you say there is really no exact level or right level of taxation. Yes, there is. Every government knows exactly the right level, and that is the people want for the government provided, paid for—and in fact if they do not, of course, they lose their credit rating.

Governor Bush knows down in Florida. He has canceled out tax cuts because he wants to hold that revenue and pay for the government that level of taxation. But up here, there is no tomorrow; we just keep on talking.

You mentioned tax cuts from surplus. We have not had a surplus since Lyndon Baines Johnson in fiscal years 1968–1969. Last year, on September 30, we ended up with a $143 billion deficit. Where do you get all of this surplus?

Right this minute, I asked them to go check, because the Secretary of the Treasury puts out the public debt to the penny, and the debt has gone up another $109 billion since October 1.

So we are all talking about tax cuts and surpluses and everything else—that is old Kenneth Lay. That is what he said—man, this company is really rich, it is going big—right until the last quarter, people were buying the stock, because we were puffing the wares down there at Enron, and we were puffing the wares up here at the Federal level.

Specifically, Mr. Daniels, you said a percentage of receipts or tax cuts did not really affect it, because it goes up, up, and away—but again, you are counting trust funds.

If you turn to page 32 of your particular historic tables, you will see there that the individual income taxes from 2000 went from $49.6 billion to $47.5 billion, and then the table shows that corporation income taxes go from $10.2 billion down to $9.7 billion—but it is only the social insurance and retirement receipts that go up, from $32.2 billion to $35.3 billion. So that is what you are using. You are using the retirement funds to pay the Government debt.

Are you familiar at all with the Pension Reform Act of 1994?

Mr. DANIELS. Somewhat, yes, sir.

Senator HOLLINGS. It made it a felony to get at these rascals like Carl Icon and so on who had these corporate takeovers, and they would pay down the company debt with the retirement funds and then take the rest of the money and leave. So we made it a felony, and I have already said it—Denny McLean ad nauseam—the poor fellow has probably served his time and is out now, and more power to him. But we treated it as a felony for corporate America because we are all worried up here about Enron and not about ourselves. That is what gets me. We hear the talk. If I go home, and I run for Governor, I have got to pay the debt. We have got to maintain our AAA credit rating. But if I want to be elected Senator, I do not want to pay the debt, I want to have tax cuts, tax cuts, tax cuts.

It is the same voter and everything else, because they do not understand what is going on. The debt is going up, up, and away, and the interest costs are going up, up, and away, and it is an absolute waste. For a sales tax, you might get a school; for a gas tax, you might get a highway. But the interest cost you cannot avoid. You have got to pay it, and it is right at $360 billion, and you project it is going to $440 billion. That is waste, fraud, and abuse.

Do you disagree with that?

Mr. DANIELS. Well, yes, sir.

Senator HOLLINGS. Why?

Mr. DANIELS. Well, how much time do I have?

Let me pick out the points I agree with. It is a very good idea to pay down debt when we can. We expect to be back to doing that as soon as the economy begins to grow again. That is what it all depends on.

There are a couple of differences between here, your responsibilities, and the President's and those of the Governor of any State, starting with the fact that a Governor does not have to fight wars and does not have to defend the safety of the American people. This budget says——

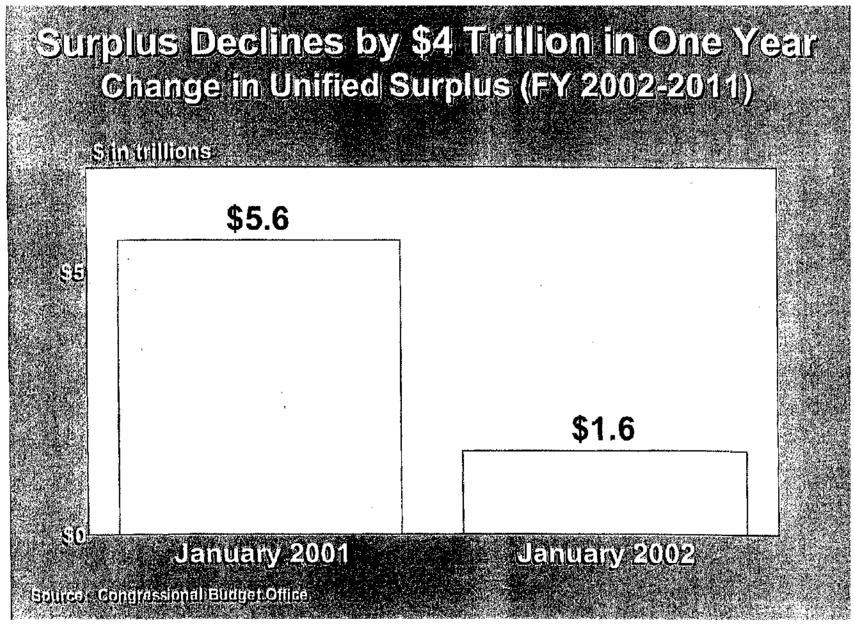
Senator HOLLINGS. But in every war, we have really raised the taxes to pay for it.

Mr. DANIELS. Sometimes with bad consequences. I think the surtax of the late sixties was yet another mistake that was made in that time, when they paid for the war all right, but they let spending run as we propose not to let happen; they practiced the so-called guns-and-butter and piled extra taxes on top of it. I think it was undoubtedly another mistake that led to a very bad economic decade that followed.

Again back to the analogy to the private sector, we have got to be a little bit careful because again, the private sector cannot take pension funds and pay off its bondholders, either. That is exactly what we do and what you are arguing that we should do—and it is the right thing to do, by the way, in the Federal context. I am just saying that the analogy is not a perfect one.

Senator HOLLINGS. Thank you.

Chairman CONRAD. The ranking member raised a number of issues that I want to address. He put up a chart talking about the biggest reason for the decline in the surplus for 1 year is the recession, and that is exactly the case. But that misses the point that over the 10 years, the biggest reason for the reduction in the surplus is the tax cut. The tax cut is 42 percent of the reduction in the so-called surplus; 23 percent was the recession; 18 percent, the spending from the attack on the country; 17 percent, technical differences, largely Medicare and Medicaid expenditures being greater than anticipated.



The Senator from New Mexico mentioned three items the Majority Leader brought to the floor—the farm bill, which is in the President's budget. He mentioned railroad retirement. That was supported by a strong majority of Republicans and Democrats in the House and the Senate. And he mentioned Senator Byrd's proposal for $15 billion of additional spending for homeland security. That is less than the increase for homeland security that is in the President's budget.

So these spending initiatives have been endorsed by Republicans and Democrats. They were not a matter just supported by the Majority Leader.

The thing that I find most troubling here today, and I do find it troubling, is that we are blithely going down the path, under the President's direction, of taking vast amounts of money from the trust funds of Social Security and Medicare and using it to pay for other purposes.

I believe, Mr. Daniels, that you and the President will be judged very harshly by history with respect to your stewardship of the fiscal condition of the country, because while you say you are not letting spending go wild, you are letting deficits and debt go wild.

When I was driving in yesterday, and I heard the description of Enron's circumstance, they were pointing the finger at the culprit as being a failure to deal with the debt—hiding debt, hiding it from creditors, hiding it from investors. And I really believe that the Federal Government is doing much the same thing here.

You are basically covering your additional tax cut proposals and ones that you have already made and your additional spending by taking money from trust funds. You say it does not matter. You say the trust funds are fully credited with those moneys, so it does not matter how the money is actually used. Of course it matters.

If you were in the private sector running a corporation, you could not take the retirement funds of your employees and use them to fund operating expenses or bonuses for the executives——

Mr. DANIELS. Or payments to bondholders.

Chairman CONRAD. No. You could not. That is the reason I set aside $900 billion last year to fund the transition of Social Security to deal with this long-term problem and to begin to deal with it.

But now we are told that it just does not matter—you can take that money and use it for other purposes. That is going to come home to roost. Those chickens are going to come home to roost, and they are going to come home to roost in the way that Director Crippen described.

A future Congress and a future President are going to be faced with extraordinarily difficult choices—massive increases in taxes, dramatic cuts in benefits, or massive debt. That is where we are headed, and you are not facing up to it in this budget; the President is not facing up to it. Instead, your proposal is to dig the hole deeper, with more tax cuts, more spending. And I believe that history will judge your harshly.

Mr. DANIELS. I believe that history would judge this President harshly if he did not defend this country, if he did not win the war against terrorism. That is what the spending is for.

Chairman CONRAD. Are the tax cuts for that, Mr. Daniels? Are the tax cuts that are 42 percent of the reason for the disappearance of the surplus what are being used to wage the war on terrorism?

Mr. DANIELS. First of all, Senator, you've got many, many chances to raise taxes on the American people. The moneys are not gone. Senator Domenici's numbers are unassailably correct——

Chairman CONRAD. For 1 year. You know, we are engaged in something more than 1 year. We are dealing with the fiscal direction of this country for years to come. You are not up here with a 1-year plan. You are up here with a 5-year plan with 10- and 15-year consequences.

Mr. DANIELS. Oh, I beg to differ. We are here with a 1-year budget and 5-year forecast, and I do not know how many years before I can go back to private life I will be sentenced to come here and discuss this stuff with you all, but as long as I am here——

Chairman CONRAD. Haven't you enjoyed this opportunity this morning?

Mr. DANIELS. I am just kidding. But undoubtedly, circumstances will change dramatically as they did last year. None of us could have foreseen the situation in which we would find ourselves, and it will change many times over the next few years.

The single most important thing beyond protecting the safety of Americans, on which I believe this President will be judged, will be his ability to maintain the conditions where the American economy can thrive, and if it does, we will have very large surpluses, and we will be able to celebrate a quick return to paying down debt, which I commend you yet again for your determination to see us do. But we ought not lament that somehow we have lost our flexibility to deal with events. We have not at all. The tax relief that the President believes is both fair and appropriate for our economy has not happened yet. Eighty or 90 percent of it has not occurred.

It can be revisited annually, and I would guess that this committee will seek to do that.

Senator STABENOW. Mr. Chairman, if I might ask a question.

Chairman CONRAD. Senator Stabenow.

Senator STABENOW. Thank you.

Just as a followup to that specific point, Mr. Daniels, you have talked several times today about raising taxes, which no one that I have heard of on either side is proposing to do for the record. But I would like to ask you a question that relates to something that is happening in Michigan right now.

A couple of years ago, the Michigan legislature, with the strong support of Governor Engler, passed a phaseout of what is called in Michigan the "single business tax." It will be phased out in I think it is 10 years, every year going down by a certain amount. But they put in a budget trigger so that if their rainy day fund, surplus fund, went below $250 million, then, the next phase would not take place until they were able to keep a floor of $250 million in their rainy day fund. And this year, there is a question about that.

I am just curious—do you think that Governor Engler and the Michigan legislature would be guilty of raising taxes if that trigger were to occur?

Mr. DANIELS. Senator, I am not particularly interested in the semantics of this or in debating that with you. I think the choice is one between higher taxation and lower taxation, and I have tried to make the case that ours is not an undertaxed society and that we have got to be careful about even higher rates of taxation if we want a strong economy, if we want the surpluses that only a strong economy produces.

It is a strong economy that produces surpluses, not the other way around. So there are——

Senator STABENOW. But in this case—because no one is talking about raising taxes; it is a question of how they phaseout and to whom, whether we have an alternative minimum tax so that everyone contributes to the national defense or not—but in this case, I assume, then, you would suggest or say that Governor Engler and the Michigan legislature would be raising taxes if the budget trigger were to take effect, and they would delay the repeal for a year. That is the same thin that you are saying here.

Mr. DANIELS. I leave this characterization to the people of Michigan. They have a great Governor, and I am sure they will come to the decisions that are right for Michigan.

It is not a parallel. There are a lot of differences, as we said earlier, between State situations and the Federal. Many States have capital budget opportunities that are akin to the borrowing that the Federal Government does from time to time, and most fundamentally, only the Federal Government has the responsibility for the security of this country, and in a time like this, that comes first, even ahead of things as important as paying down debt.

Senator STABENOW. Thank you, Mr. Chairman.

No one was objecting to the issue of national defense.

Thank you.

Chairman CONRAD. No—and I want to make that clear as we end here today. As I began this discussion, we praised the President and the Administration for their handling of these attacks against our country.

I remember so well September 11. I was in the Capitol, and we were told by security people that it might be the focus of an attack. And no one knew where that fourth plane was headed, whether it was headed for the White House or perhaps another strike on the Pentagon or the Capitol complex itself.

And as I said earlier today, I have been proud as an American of the way the President has conducted himself and the Administration in responding to these attacks; I genuinely have been.

Where I believe you will be judged harshly and I believe the President will be judged harshly is taking us back down the road to deficits and debt—not on a 1-year basis, not this year, at a time of war and recession—but for many years to come, because you have not balanced the spending and the revenue of this Government. You have not. You are digging the hole deeper, and in this proposal you continue that practice. I think it is profoundly wrong. I think it is a huge mistake, and we will pay a great price in the future.

And I say that to you just as directly as I can, without animus or anger, but with the belief that that is the fact.

Again I thank you very much for being here today.

[Whereupon, at 12:35 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR SARBANES TO DIRECTOR DANIELS AND THE RESPONSES

SEC PAY PARITY

Question: Last year, the Congress passed the Investor and Capital Markets Fee Relief Act (P.L. 107-123) which reduced fees charged to investors and public companies by a projected $14 billion over 10 years and authorized the SEC to pay its employees on a par with the other bank regulators. Raising SEC employee salaries is critical to reducing turnover and maintaining the effectiveness of the agency, and would cost only $76 million for next year. And yet the Administration has not budgeted resources so that the SEC can actually exercise this authority and raise its employees' salaries. With growing concern about oversight of the accounting industry and the integrity of the markets, the strength of the SEC is extremely important. **Why has the Administration not authorized funding of the SEC's pay parity authority?**

Answer: The Administration intends to phase-in a new compensation system for the SEC to ensure that it is merit based and not merely an automatic entitlement for each employee. In this regard, we are concerned that the SEC not repeat the mistakes of some Federal banking regulators who do indeed pay their employees more than other Federal agencies but who may not have effective performance incentive programs such as those that exist in the private sector.

The Federal Deposit Insurance Corporation's recent announcement that buyouts are needed to transform that agency and the Office of Thrift Supervision's workforce reductions in 2001 and 2002 illustrate the personnel management difficulties that may arise if higher pay rates are not accompanied by such performance programs. While the scope and speed of the phase-in of the new pay and benefit provision will impact the Commission's budgetary requirements, more than $25 million in unobligated prior year funding may be available to test pay parity in FY 2003.

The President's FY 2003 Budget includes $481 million for the SEC, which is $29 million or 6 percent above the FY 2002 enacted level. Included in that total are $164 million for enforcement and $67 million for disclosure, which is a 6 percent and 8 percent increase respectively over the FY 2002 enacted level. The Administration is also requesting $20 million in supplemental FY 2002 funding to increase SEC staffing by 100 full time employees (in FY 2002 and FY 2003) beyond the levels proposed in the President's FY 2003 budget. These employees will help SEC respond to the President's commitment to improving corporate governance. The SEC's FY 2003 Budget also includes $19 million for special pay, which allows for compensation beyond that provided to other general schedule and, executive schedule employees. The special pay funding along with any remaining unexpended prior funding is available to offset the cost of a phased-in compensation system in the next fiscal year.

WRITTEN QUESTIONS FROM SENATOR WYDEN TO DIRECTOR DANIELS AND THE RESPONSES

FCC SPECTRUM AUCTIONS

Question: Last fall, in the Statement of Administration Policy on the Agriculture Appropriations Bill for FY 2002, OMB stated: "The Administration would strongly oppose any amendment that would restrict the FCC's ability to assign, via competitive bidding, satellitel spectrum licenses that could be used by terrestrial (i.e., non-satellite) services. *Such a provision would interfere with the efficient allocation of Federal spectrum licenses, provide a windfall to certain users, and reduce Federal revenues*." Does that remain the Administration's position today?

Answer: Yes. The Administration continues to oppose any unnecessary restriction of the FCC's auction authority.

Question: If the FCC decides to permit the use of satellite frequencies for terrestrial mobile services, would it be the Administration's intent to make that terrestrial service available to all qualified entities and to assign it via auction? Would the Administration position be the same with respect to terrestrial authorizations on any satellite band?

Answer: If the FCC decides to permit the use of frequencies currently allocated for satellite services for terrestrial services, it is within the FCC's authority as an independent agency to devise the service rules for such frequencies, which will determine the qualified entities to use such spectrum, and to assign licenses to use such frequencies via auction under its statutory mandate to assign licenses for which there are mutually exclusive applications by competitive bidding. The Administration does not have direct authority to make such decisions but can attempt to influence the process through filings with the FCC and through legislative proposals.

Question: What are the assumptions in the Administration's budget regarding spectrum auctions for fiscal year 2003? What are the assumptions for the outyears? Would those assumptions be changed if the FCC were to decide to allocate satellite spectrum for new terrestrial uses without assigning those terrestrial allocations by auction?

Answer: The FY 2003 Budget baseline includes the following estimates for spectrum auction receipts:

(in millions of dollars)

2003	2004	2005	2006	2007	2008
4,510	10,565	8,770	675	680	685

If the FCC decided to allocate spectrum currently allocated for satellite services for new terrestrial uses without assigning those terrestrial authorizations by auction, estimated future spectrum auction receipts would be reduced by several hundred million dollars.

Question: Would the Administration's budget assumptions for spectrum auction revenue be different if the FCC proceeded to auction the 700Mhz band (channels 52–69) without first establishing an alternative plan for incumbent licensees that currently occupy that band?

Answer: The FY 2003 Budget baseline estimate for the 700 MHz auctions assumes that the FCC will proceed with the auctions as currently planned. That is, that the auctions will be held without establishing plans for removing the broadcasters who currently occupy the band that are any different from what is currently foreseen under the FCC's rules for the 700 MHz auctions. Baseline revenue estimates for the 700 MHz auctions (channels 52–69 or 78 MHz of spectrum) are $5.4 billion. The proposal in the FY 2003 Budget to shift the auction deadlines and establish clearing procedures for channels 59–69 would increase receipts by an estimated $6.7 billion, for a total of $12.1 billion for channels 52–69.

WRITTEN QUESTIONS FROM SENATOR BOND TO DIRECTOR DANIELS AND THE RESPONES

HUBZONE PROGRAM

Mr. Director, I appreciate the President's request to fund the Small Business Administration's HUBZone program at $2 million for 2003. The HUBZone program is a particular interest of mine, since I wrote the HUBZone Act during my tenure as Chairman of the Senate Small Business Committee.

I also commend the Administration, in general, for trying to identify underperforming programs and reforming them. But I was surprised to find the HUBZone program attacked, on pages 351–2 of the budget. The budget states:

> "a recent study by the General Accounting Office cited poorly designed eligibility criteria and burdensome and costly application processes as barriers to small business participation in the HUBZone program."

Now, I was the one who commissioned that GAO study, and I know for a fact it does not say anything at all like that. The study notes a lack of certified HUBZone firms, but does not attribute this to overly strict eligibility criteria. Instead, this may be purely a function of eligible firms not knowing that they are in fact eligible.

Second, the report says nothing—nothing at all—about a "burdensome and costly application." In fact, the HUBZone program's on-line application is something of a model for delivering Government services over the Internet.

Instead, GAO noted a major problem was the Clinton administration's effort to subordinate the HUBZone program to the 8(a) program—a policy which is being reversed, thanks to publication of new HUBZone rules.

I am concerned that, after generating a useful report in the HUBZone program, GAO is being characterized as making statements they did not in fact make. If the goal is to identify actual weaknesses and correct them, these statements in the budget are counterproductive.

Questions:

- In the GAO report *HUBZone Program Suffers from Reporting and Implementation Difficulties*, dates October 26, 2001 and released publicly in November (GAO–02–57), *where does GAO criticize "poorly designed eligibility criteria"? Please provide a page citation to the report*. • Also in the GAO report, *where does GAO criticize "burdensome and costly application processes"? Please provide a page citation to the report*.
- In my view, the HUBZone program office has done an excellent job of using Internet technology to bring this program to the public, through its on-line application process. In your view, *is the HUBZone program's electronic application consistent with the Administration's e-government initiatives*?
- *Has the 8(a) program begun incorporating a similar e-government approach? What portion of the 8(a) application, if any is usable on-line? When do you expect that the 8(a) program will make full use of the Internet to allow eligible firms to apply*?

Answers: In citing the HUBZone program in the Budget, our intention was not to find fault but rather to identify deficiencies either in design or execution that when corrected could help better deliver the services envisioned in the program's enactment. GAO did not specifically criticize "poorly designed eligibility criteria" or "burdensome and costly application processes" in its review of the HUBZone program. However, GAO identified a number of areas for improvement in program reporting and implementation that SBA is now working to correct. The Budget document paraphrases some of these concerns.

Specifically, GAO reported that agencies have trouble identifying qualified HUBZone firms. Contracting officers attribute this to the relatively small number of HUBZone certified businesses. In many cases, the information firms provide in SBA's PRO-*Net* database is not specific or reliable enough to ascertain the firms capabilities. SBA agreed with GAO's recommendation to help contracting officers identify firms capabilities and inform firms of the importance of maintaining timely and accurate information in the PRO-*Net* system. SBA will also intensify its efforts to increase the currency of PRO-*Net* records. In addition, GAO stated that agencies are unsure of what qualifies as a HUBZone contract due to the lack of SBA guidance. SBA has committed to developing guidance to clarify this issue.

The HUBZone on-line application process is consistent with the Administration's e-government initiatives. In fact, SBA is using it as the model for all of its small business certification programs. It is our understanding that the electronic 8(a) application process proposal is being prepared for review through SBA's Capital Planning and Investment Control process, as required by the Clinger-Cohen Act. We anticipate that a substantial portion of the information currently collected in the paper application would be instead collected through an on-line application.

On a broader note, we anticipate that the President's Small Business Agenda will increase contracting opportunities for all small businesses, including HUBZone firms.

WOMEN-OWNED BUSINESS CONTRACTING GOAL

As we ramp up our spending on defense and homeland security needs, the role of contractors must inevitably increase. It does no good to increase spending if we do not have a diverse vendor base able to sell the Government the goods and services it needs.

I am concerned that small business will not get the fullest opportunity to participate in these contracts. Whenever contacting officers need to act quickly, they often turn to the same contractors they've used in the past, usually large ones. As a result, they often overlook the better values available from small firms—the source of so much innovation in our economy.

In particular, I'm concerned about the 5 percent goal for women-owned small firms to participate in Federal contracting. On October 18, 2001, I wrote you about the need for the Government to get serious about this goal, and urged you to communicate this need to agency heads and put them on-notice that they will be held accountable for it. On November 30, you responded that OMB's Office of Federal Procurement Policy has begun "working closely" with the agencies. OFPP has also begun meeting with women business groups to improve outreach to those firms.

Questions:

- *What specific actions has OFPP taken to hold agency heads accountable for the women business-contacting goal*?
- *What have you learned from meeting with women business groups? What actions have you taken to implement their recommendations*?
- *Will the Government meet the 5 percent women business goal this year? If not, why not*?

Answers:

The President recognizes the enormous role small businesses play in our national economy. The President's Small Business Agenda will give small business owners the jump-start they need to create new jobs, support their workers, and improve our economy. The Administration is committed to: providing new tax incentives; giving small business owners more power to provide health care for their uninsured employees, and improving the health care options for employees who already have insurance; tearing down the regulatory barriers and giving small business owners a voice in the complex and confusing Federal regulatory process; saving taxpayers dollars by ensuring full and open competition to government contracts; and providing small businesses with the information they need to succeed. OFPP and other Federal agencies are working to implement the President's Small Business Agenda. We anticipate that the President's Small Business Agenda will increase contracting opportunities for all small businesses, including women-owned firms.

Recently, the Department of Labor and the Public Forum Institute hosted the "Women Entrepreneurship in the 21st Century" Summit. Over 1,000 women entrepreneurs participated in this forum to address the most pressing concerns of women business owners today. In a survey conducted at the summit, 59 percent of women business owners, when asked to project their level of participation in the Federal marketplace in the next 12 months, indicated that they needed more information. We recognize that more needs to be done to ensure that available information reaches women entrepreneurs. However, through a variety of resource partners, SBA already provides small business owners with information on how to contract with the Federal Government. SBA provides valuable information to women-owned small businesses through its Online Women's Business Center and through womenbiz.gov, the online gateway for women-owned businesses, which is co-sponsored by SBA's Office of Contracting Assistance for Women Business Owners.

While the Federal Government did not meet the 5-percent women-owned small business goal in FY 2001, it did improve its performance. Preliminary estimates show that 2.45 percent of Federal procurement dollars were awarded to women-owned small businesses, an increase of $700 million over FY 2000. This is certainly a step in the right direction and we recognize that more needs to be done to understand the obstacles to increasing the participation of women-owned businesses in Federal contracting.

WRITTEN QUESTIONS FROM SENATOR SNOWE TO DIRECTOR DANIELS AND THE RESPONSES

FCC SPECTRUM AUCTIONS

Question: What are the assumptions in the Administration's Budget regarding spectrum auctions for FY 2003, and for the subsequent outyears?

Answer: The FY 2003 Budget baseline includes the following estimates for spectrum auction receipts:

(in millions of dollars)

2003	2004	2005	2006	2007	2008
4,510	10,565	8,770	675	680	685

Question: How would those assumptions be changed if the FCC decided to allocate 1satellite spectrum for new terrestrial uses without awarding those terrestrial authorizations by auction?

Answer: If the FCC decided to allocate spectrum currently allocated for satellite services for new terrestrial uses without awarding those terrestrial authorizations by auction, estimated future spectrum auction receipts would be reduced by several hundred million dollars.

Question: Further, how would the budget assumptions for spectrum auction revenue be different if the FCC proceeded to auction the 700 MHz band (channels 52–69) without first establishing a definitive plan for removing the broadcasters who currently occupy that band?

Answer: The FY 2003 Budget baseline estimate for the 700 MHz auctions assumes that the FCC will proceed with the auctions as currently planned. That is, that the auctions will be held without establishing plans for removing the broadcasters who currently occupy the band that are any different from what is currently foreseen under the FCC's rules for the 700 MHz auctions. Baseline revenue estimates for the 700 MHz auctions (channels 52–69 or 78 MHz of spectrum) are $5.4 billion. The proposal in the FY 2003 Budget to shift the auction deadlines and establish clearing procedures for channels 59–69 would increase receipts by an estimated $6.7 billion, for a total of $12.1 billlion for channels 52–69.

MANUFACTURING EXTENSION PARTNERSHIP

Question: Director Daniels, why have you decided to so significantly reduce the funding for a program that has been so successful, especially at a time of economic downturn when the Nation's small manufacturers are in need of the important technical assistance the MEP is in existence to provide?

Answer: The Administration's priorities for the 2003 budget are combating terrorism, protecting the homeland, and strengthening the economy. These priorities reflect changing needs and require making difficult budgetary choices. After a careful reexamination of the program, the Administration decided to limit Federal funding for MEP to program coordination and support of newer centers in 2003.

MEP's original design called for Federal funding for centers to end after six years. The intent was that the centers, which provide services similar to private consultants, would be self-sustaining after this start-up period. By 2003, most centers will be much more than six years old. It is reasonable to expect that fee receipts could replace Federal funding for the centers. The gains realized by small firms as a result of MEP assistance, such as improved productivity and efficiency, should increase profits and outweigh the cost of the services.

ARS NEW ENGLAND PLANT, SOIL AND WATER RESEARCH LAB

Question: Could you give me assurances that the New England Plant, Soil and Water Research Laboratory will not only remain open and running with its current staff but will also include the agricultural scientist position and the funds for the expanded research on potato late blight research as appropriated in FY 2002? If you cannot respond today, could you please get back to me as soon as possible as the research laboratory is very important to me and to my State of Maine.

Answer: As part of its effort to manage its field structure of research facilities in the most cost-effective manner and to maximize the ability of its scientists to undertake modern research activities, USDA has proposed to close or terminate research functions at 11 of its research facilities, including the New England Plant, Soil and Water Research Lab at Orono, Maine. Orono was proposed for closure for a number of reasons, including its small size and the fact that similar work was being performed elsewhere.

When determining which facilities to close, USDA used recommendations included in the "Report of the Strategic Planning Task Force on USDA Research Facilities". This task force was authorized in the 1996 Farm Bill, and was tasked with developing a "10 year strategic plan, reflecting both national and regional perspectives, for development, modernization construction, consolidation and closure of Federal agricultural research facilities and agricultural research facilities proposed to be constructed with Federal finds." The Report recommended that a number of facilities be closed, including the site in Orono.

However, while the existing plant, soil and water research lab is proposed for closure, $5.5 million in *FY 2001 and FY 2002 construction funds have been appropriated for the new Northeast Marine Cold Water Aguaculture Research Center that is to be located in Orono, Maine*.

WRITTEN QUESTIONS FROM SENATOR SMITH TO DIRECTOR DANIELS AND THE RESPONSES

VETERANS AFFAIRS

Question: According to many VA sources, the FY 2002 VA medical care budget is about $800 million short. Last year, the President asked for a $1 billion increase and Congress increased that request by $300 million. Yet, upon enactment of the FY 2002 budget, VA Secretary Principi was about to stop allowing enrollment of new Priority Group 7 VA patients. Priority Group 7 includes recently separated veterans from the armed forces—our newest American heroes. Thankfully, President Bush directed Secretary Principi to continue enrolling all new VA patients. *Why was the FY 2002 budget request for VA medical care well below the obvious need and will the Administration be seeking a supplemental*?

Answer: Prior to FY 1999, the care for higher-income, non-disabled veterans (Priority Level 7) was not 1directly funded in budgets submitted by Administrations or passed by Congress. These veterans were treated on a space-available basis. The Eligibility Reform Act of 1996 allowed VA to treat all enrolled patients, and placed into effect a prioritization system to ensure that the quality of care for the highest priority of veteran was not jeopardized by opening up the system to these new veterans. The use of the VA system by this new group of veterans has grown from 2 percent of patients in 1996 to 21 percent today, and it is projected to be 42 percent by 2010. This overwhelming response to care was not foreseen. In 2002, the VA medical care system is experiencing a 15 percent increase in patients over the budget estimate. VA estimated the FY 2002 shortfall to be $142 million—and this amount is included in our recent supplemental request.

Question: Several veterans' organizations have expressed to me that the $1.7 billion increase you are requesting in FY 2003 for VA medical care may still be inadequate. *What changes did you make in determining the estimated cost of continuing to deliver quality health care to America's veterans*?

Answer: The Administration is proposing a new $1,500 annual deductible for lower-priority (PL 7) veterans (non-disabled and higher-income). Under law, lower-priority veterans have always paid a portion of their care through co-payments. Escalating numbers of PL 7 veterans require their increased cost sharing in order to focus appropriations on the core veterans. PL 7 veterans would annually pay 45 percent of the charge for medical services until their out-of-pocket expenses total $1,500. If all projections, funding levels, and the new deductible are realized, VA should be able to continue open enrollment to all veterans in 2003. Without the deductible, VA would need $1.1 billion more to continue open enrollment.

Question: While the number of veterans is declining, the average age of veterans is increasing, meaning an increase in the number of VA patients. *If the VA patient population is increasing at such a dramatic rate, why doesn t the VA budget reflect an equitable increase in health care professionals*?

Answer: The VA patient population is dramatically increasing mainly because of the influx of PL 7 veterans into the system who did not have access prior to 1999. The number and type of health care professionals is constantly assessed by VA given the anticipated population, the mix of contract and direct treatment care, and the ever-changing needs of the fast-moving health care environment. For example, VA (like the private sector) is moving away from institutional care and more towards outpatient and home health care to ensure that veterans are treated in the most practical and humane environment.

Question: With enactment of the Veterans' Millennium Health Care and Benefits act (P.L. 106 117), VA has an obligation to provide long-term care for more veterans. *What funding in the FY 2003 budget provides for this Federal Mandate*?

Answer: The FY 2003 budget requests over $3.6 billion for geriatrics and long-term care. In addition, the Budget requests that VA be allowed to account for census increases in community and State nursing homes for FY 2003.

Question: It is my understanding that it may actually save taxpayers if the VA served additional veterans whose care is currently paid by Medicare, and if the VA provided that care less expensively than other health care providers who would be reimbursed through Medicare. *Would you support allowing veterans to use Medicare dollars at VA facilities without reducing the VA appropriation*?

Answer: This is a complex issue with a potential wide-range of care and market repercussions (locally and nationally). We are not prepared to endorse the initiative without a fill understanding of the consequences.

Question: Every Member of Congress has heard from their veterans about fill concurrent receipt of military retirement pay and VA disability compensation without the current dollar-for-dollar offset. In essence, military retirees are paying for their own VA disability compensation with their longevity retirement paychecks. *Does the FY 2003 Defense spending request include funding for concurrent receipt as addressed in the FY 2002 Defense authorization act*?

Answer. The principle behind the prohibition is the idea that no one should be able to receive concurrent retirement benefits and disability benefits based upon the same service. A retired civil servant, for example, may not receive civil service disability benefits or workers compensation benefits in addition to civil service retirement benefits. A similar ban exists against concurrent payment of retirement and disability benefits by the Social Security Administration.

On December 28, 2001, President George W. Bush signed into law the National Defense 1Authorization Act, 2002 (Public Law 107-107), which contained a provision removing one of the barriers prohibiting concurrent receipt of military retired pay and VA disability compensation benefits. However, the new law did not provide the additional funding needed to begin the concurrent payments, and it specifically requires additional legislative action that must be taken before any concurrent payments can be made. Concurrent receipt would cost $58 billion over ten years—$42 billion associated with the additional payment of retired pay, and $16 billion associated with payment of VA disability compensation under claims that would not otherwise be submitted. VA estimates that enactment would result in 700,000 original claims and 118,000 reopened claims over the next five years. Adjudicating these claims without increasing existing backlogs and timeliness would require an additional 2,514 employees. This amount would require either increasing tax revenues or decreasing spending in other program areas in amounts 1equal to the extra costs.

Question: I have heard from many veterans who experienced lost records when their records were transferred from the Department of Defense to the Department of Veterans Affairs. *Will the FY 2003 budget allow for technological enhancements to improve the transfer of information so that future veterans will not suffer lost records*?

Answer: The President has two important information technology initiatives that should help solve this 1problem. First, the President's Management Agenda includes an initiative that would improve the VA enrollment systems. Such a system should make transition from active duty to veteran status seamless and include the eligibility and enrollment status for each of the numerous DoD and VA benefits. For over 20 years, the DoD has operated a centralized automated system to enroll and track individuals having entitlements to DoD benefits and services called the Defense Enrollment/Eligibility Reporting System (DEERS). DEERS is a large database that accurately records the benefits eligibility information for over 20 million beneficiaries in multiple government agencies and could be expanded to include VA. DEERS is uniquely positioned to bridge the gap between the two Departments. It already supports a modest level of real-time exchange of information on veterans, setting the stage for even closer cooperation. The Departments are exploring their mutual options in this area. While there may be some up-front costs of using DEERS for VA, there should be long-terms savings.

The second key area of coordination of information technology that we are addressing is in the medical care area. Both DoD and VA create independent patient medical records when a beneficiary uses its health care systems just as files are created for you when you visit your doctor. Each Department has aggressively moved towards computerizing these records to allow all medical providers throughout its own system to access and rapidly update individual patient records. Since all veterans start out in the DoD system and hundreds of thousands of them use both systems annually, it is imperative that this effort be coordinated. This challenge can be achieved and would improve overall health care. Currently, if a patient sees a DoD doctor on Wednesday, it is very difficult to ensure that treatment and medication are consistent with those the patient obtained from a VA doctor on Monday. Managing care is critical to well-being. One of the Administration's E-Government initiatives is Health Care Informatics, and development of a patient record system falls under its scope. Hence, developmental efforts in both Departments will focus on interoperable information technology solutions. This is a major effort, which will likely require a sustained, multi-year effort to implement completely.

SMALL BUSINESS PRPGRAMS

Question: Two prime grants are currently supporting ten programs around the State (OR) in their efforts to serve disadvantaged microentreprenuers. These programs serve Lincoln City, Yamhill County, Northeast and Southeast Portland, Ontario, Lane County, Coos, Curry and Douglas Counties, and Josephine, Jackson Klamath and Lake Counties.

Citing duplication, the budget would eliminate PRIME, as it proposed last year, but Congress restored modest funding. It is my understanding that PRIME is not duplicative, as suggested in the Administration's budget, rather it emerged from an extensive survey of microenterprise practitioners who cited the lack of basic business training and support for lower-income entrepreneurs. Unlike other SBA programs, PRIME's legislation targets low-income individuals, regardless of whether they take out loans. It serves a very important niche within the microenterprise market. PRIME has always enjoyed bi-partisan support, it has never been controversial and yet, it seems this budget proposes to eliminate one of the most promising small business programs in the government. *Do you really think it makes sense to reduce basic business training for people who have shown the desire and inclination to start a very small business? Doesn't this type of training make common sense and help very small businesses grow*?

Answer: The President's Budget does not request additional funding for the Program for Investment in Microentrepreneurs (PRIME) because we believe its objectives can be achieved through other Small Business Administration (SBA) programs. Specifically, SBA operates Business Information Centers (BICs) where entrepreneurs can get information and counseling by volunteers through the Service Corps of Retired Executives (SCORE) on a range of issues facing start-up and existing small businesses. SBA works with the over 1,000 Small Business Development Centers nationwide to provide management assistance to current and prospective small business owners. The SBDC network includes centers in the following Oregon cities: Albany, Bend, Eugene, Grants Pass, Gresham, Klamath Falls, LaGrande, Lincoln City, Medford, Milwaukie, North Bend, Ontario, Pendleton, Portland, Roseburg, Salem, Seaside, The Dalles, and Tillamook. SBDCs offer one-stop assistance to small businesses by providing a wide variety of information and guidance in central and easily accessible branch locations.

Question: Mr. Daniels, the Microloan program has begun to flourish as demand for its services has increased dramatically over the past five years. This program now has $110 million in loans outstanding and will have more than $130 million next year. These funds are then relent by non-profit intermediaries—including three excellent programs in Oregon—in loans averaging just $15,000 which are followed by intensive technical assistance to grow these start-up businesses. This technical assistance has been key in building business and protecting the investment the SBA makes in them. Last year, the SBA ran out of loan capital. This year, technical assistance grants were cut by 40 percent. The budget figures you propose would cause organizational funding to fall even further. *Why is the Administration not providing more support for a program that creates jobs and builds businesses—particularly in places like Oregon, which has the highest unemployment rate in the country*?

Answer: The President recognizes the enormous role small businesses play in our national economy. The President's Small Business Agenda will give small business owners the jump-start they need to create new jobs, support their workers, and improve our economy. The Administration is committed to: providing new tax incentives; giving small business owners more power to provide health care for their uninsured employees, and improving the health care options for employees who already have insurance; tearing down the regulatory barriers and giving small business owners a voice in the complex and confusing federal regulatory process; saving taxpayers dollars by ensuring full and open competition to government contracts; and providing small businesses with the information they need to succeed. We anticipate that the President's Small Business Agenda will assist entrepreneurs in every state start, maintain, and grow small businesses.

In addition, the Administration is providing support for the Microloan program. In fact, the Budget includes $3.465 million in subsidy budget authority to support over $26 million in Microloans. We agree that the technical assistance portion of the Microloan program plays a significant role in increasing the likelihood of borrower success. As such, the Budget provides $17.5 million for technical assistance.

BONNEVILLE POWER ADMINISTRATION

Question: I am pleased that the President's 2003 Budget request includes support for a $700 million increase in borrowing authority for the Bonneville Power Administration. It was my understanding that this increased borrowing authority would not subject to annual appropriations, just like BPA's current borrowing authority. *Does the Administration support this increase in borrowing authority not subject to annual appropriations*?

Answer: Yes, the President's Budget, which proposes the increased borrowing authority, would be enacted in an authorizing bill, not through appropriations. Once authorized, the increase would be treated just as BPA's existing borrowing authority is treated and would not be subject to annual appropriations.

Bush Administration officials claim that up to 6 million uninsured people would obtain health coverage next year under full implementation of a multi-pronged plan they outlined today to expand access to health care. Estimated to cost $110 (sic) over 10 years, the plan mixes coverage subsides for workers displaced by the recession, tax credits for those without employer-subsidized insurance, increased funding for community health centers, extended availability of State Children's Health Insurance Program funds, and a budget increase for the National Health Service Corps. . .all of which you have been publicly supportive of (just in higher $$ amounts).

Question: I was very happy to see that the President has increased his request this year for funds for tax credits to help the uninsured obtain health insurance. Clearly he recognizes that the problem of the uninsured is sizable—and growing—and will not go away on its own. The President's proposal is a good start in addressing the issue, but by his estimates, if implemented, his proposal will only reach 6 million of the uninsured next year. There are 40 million uninsured people in this country—and the number is growing. I would like to work with you to find a way to cover the remaining 34 million uninsured, many of whom will be from my home State of Oregon. Can you tell me how we can go about this?

Answer: I certainly agree with your interest in addressing health coverage for the uninsured. As a first step, the Administration introduced the Health Insurance Flexibility and Accountability Demonstration Initiative (HIFA) in August 2001 to give States new flexibility to increase health insurance coverage through support of private group health coverage through the Medicaid and SCHIP programs. Two states have HIFA waivers approved, and several states have submitted HIFA applications to the Department of Health and Human Services (HHS). The Administration will continue to build on the HIFA demonstration initiative in FY 2003 by developing proposals that encourage States to use program resources to reduce the number of people without health insurance coverage.

The President has introduced a comprehensive set of proposals to ensure that all Americans have affordable health insurance coverage options, with a particular emphasis on creating affordable options for the uninsured. As you mentioned, the President's FY 2003 Budget includes $89 billion for health credits for the uninsured. The President's Budget also eases the restrictions on Medical Savings Accounts (MSAs) and Flexible Spending Accounts (FSAs) to encourage employers to offer health insurance to their employees, continues Medicaid coverage for families in transition from welfare to work in FY 2003, and strengthens the State Children's Health Insurance Program (SCHIP) by making available an estimated $3.2 billion that under current law would return to the Treasury at the end of FY 2002 and 2003.

Finally, the FY 2003 Budget includes a $114 million increase for Community Health Centers to expand access to primary care and other health services. This increase builds on the Community Health Centers Presidential Initiative to increase and expand the number of health center sites by 1,200 and serve 6.1 million more patients by 2006.

THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSALS

WEDNESDAY, FEBRUARY 6, 2002

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: Senator Conrad.

Staff present: Mary Ann Naylor, staff director; and Chad Stone, chief economist.

For the minority: G. William Hoagland, staff director; and Bob Stein, chief economist.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Why don't we begin?

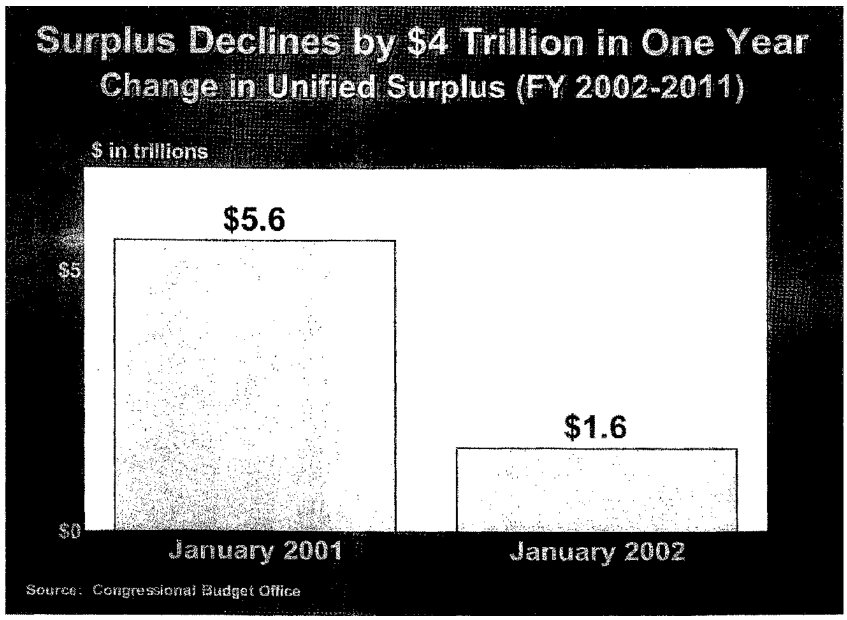
Senator Domenici will not be with us this morning. Senator Domenici went into the hospital last evening for some tests, and we certainly hope those tests find everything is positive and that he is on his road to recovery. We eagerly await his return to this committee where he plays such an important and productive role. And our thoughts are certainly with him, and I know I speak on behalf of every member of this committee that we wish him well and a speedy recovery.

I want to thank the witnesses for being here. On our side we have six Senators who have indicated they will be here at various points. As you know, this morning turned out to be a very important morning with respect to votes on the floor. I regret that for the purposes of this Committee, but those were important votes to have and important debate to have as well. Virtually every committee is meeting on the Enron question, so those are all things that are occurring which we could not have predicted when we scheduled this hearing. But I want to thank our very distinguished witnesses for being here.

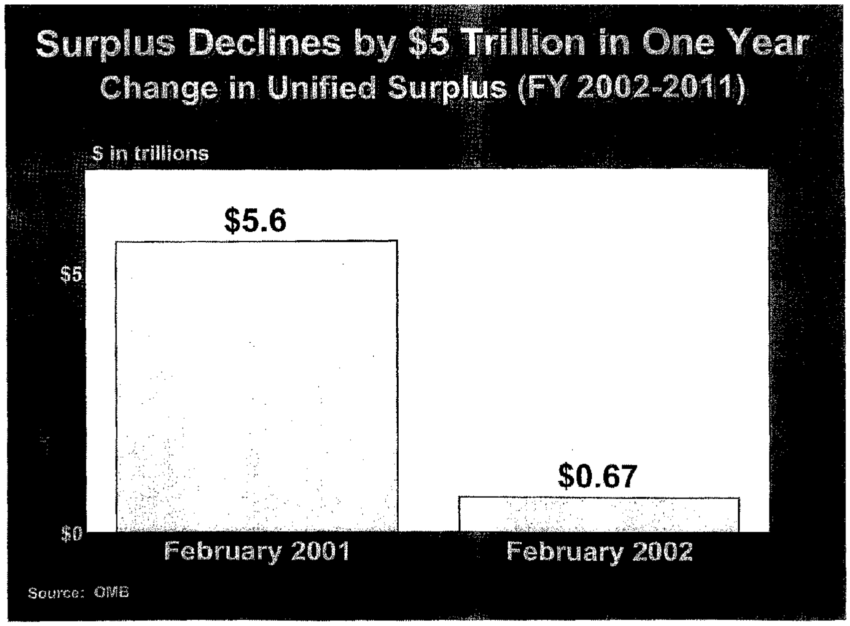
I am going to make a very brief opening statement, and then, as others arrive, we will hear from them after we have gone to the witnesses. So let me just begin.

The Director of the Congressional Budget Office delivered to us earlier the sobering news that much of the projected surpluses over the next 10 years have disappeared. Last year we were told there was going to be some $5.6 trillion of surpluses over the next 10 years. The Congressional Budget Office came back after their review, their most recent review, and said there is not going to be

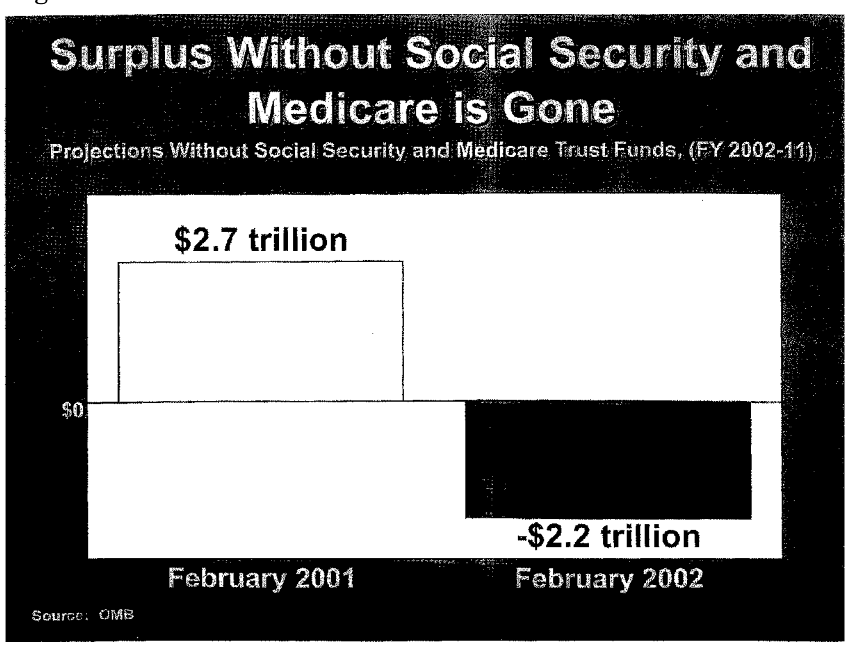
$5.6 trillion, there is not going to be $4.6 trillion, there is going to be $1.6 trillion. And that is before the President's defense buildup, before additional funds for homeland security, before his stimulus package, before a new farm bill, before a whole series of other spending initiatives that the President has proposed. And so that $1.6 trillion is clearly optimistic.



The other shoe dropped with the report to us yesterday by the President's Director of the Office of Management and Budget, Mr. Daniels, that with the President's budget, the $5.6 trillion we were anticipating is now done by their calculations, using their budgets, to less than $1 trillion, in fact, about $600 billion. That, too, is probably overly optimistic. We are informed that when the Congressional Budget Office does their review of the President's proposal that it is more likely they will come in at about $200 billion because the President's budget has given an overly optimistic view of Medicare expenses and in other areas as well.

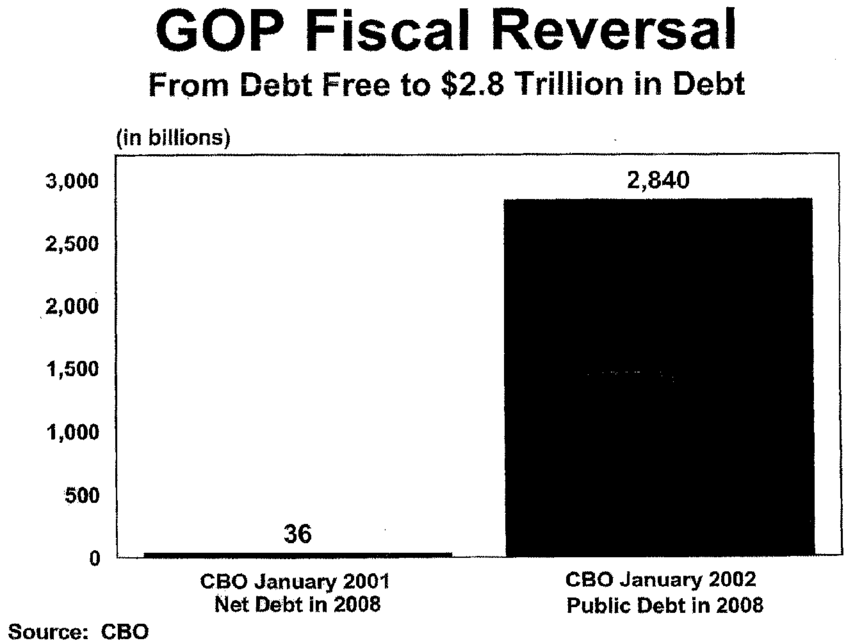


The hard reality is that the non-trust fund surpluses that we were told about last year, some $2.7 trillion, is all gone. Instead, we see $2.2 trillion of deficits on the non-trust fund side of the ledger.



What that means is very simple. It means that over $2 trillion of trust fund money, Social Security and Medicare Trust Fund moneys, are being used to pay for the tax cuts and to pay for other expenses of the Federal Government. And that has got enormous implications for the future.

The other hard reality is that last year we were told we would be virtually debt-free by 2008. The Congressional Budget Office told us last year by 2008 there would be virtually no debt. Now they are telling us, instead of no debt, we will have nearly as much debt as we have got now, some $2.8 trillion of debt in the year 2008.



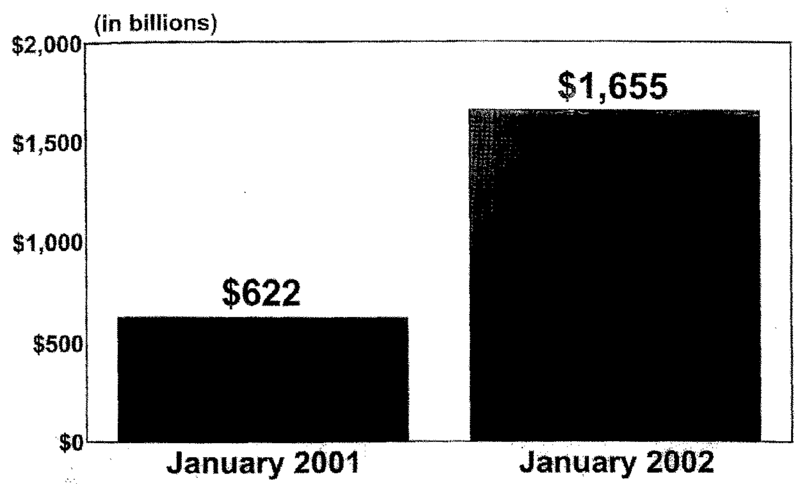
And, of course, that understates the debt because that is the publicly held debt. That does not acknowledge the trust fund debt, and that does not acknowledge what Chairman Greenspan talked to us about the other day as the long-term liabilities over and above the money that is due the trust funds. And that is in the trillions of dollars.

That is one reason I said that in many ways we confront what Enron confronted. Enron's big problem and big vulnerability was the hiding of debt, and in many ways, the Federal Government is doing the same thing, with the same consequences, perhaps, for the country as for the company—that is, financial difficulties that will flow from a failure to fully acknowledge the debt the country is facing.

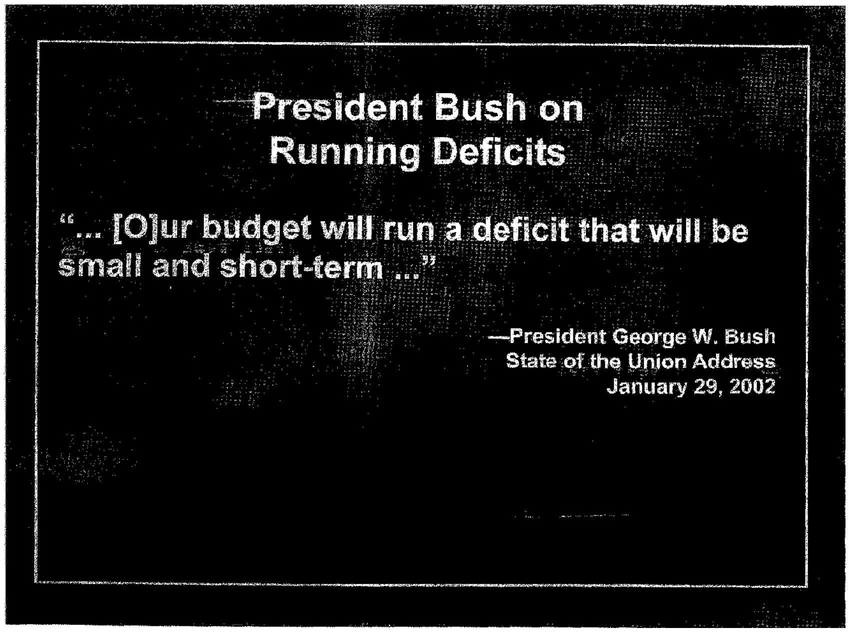
The consequence of more debt is more interest cost. CBO told us last year we could anticipate some $600 billion in interest costs over the next decade. Now they are telling us it will be $1 trillion more, some $1.6 trillion of interest costs. That means that $1 trillion of additional interest costs will not be available for productive purposes, will not be available to increase the defense of the United States, will not be available to improve the homeland security, will not be available to educate our children or build roads or bridges or other worthwhile purposes. Instead, we will be making more interest payments, as at the same time we are taking money out of the trust funds of Social Security and Medicare to pay for other things.

Total Federal Interest Costs Increase by $1 Trillion

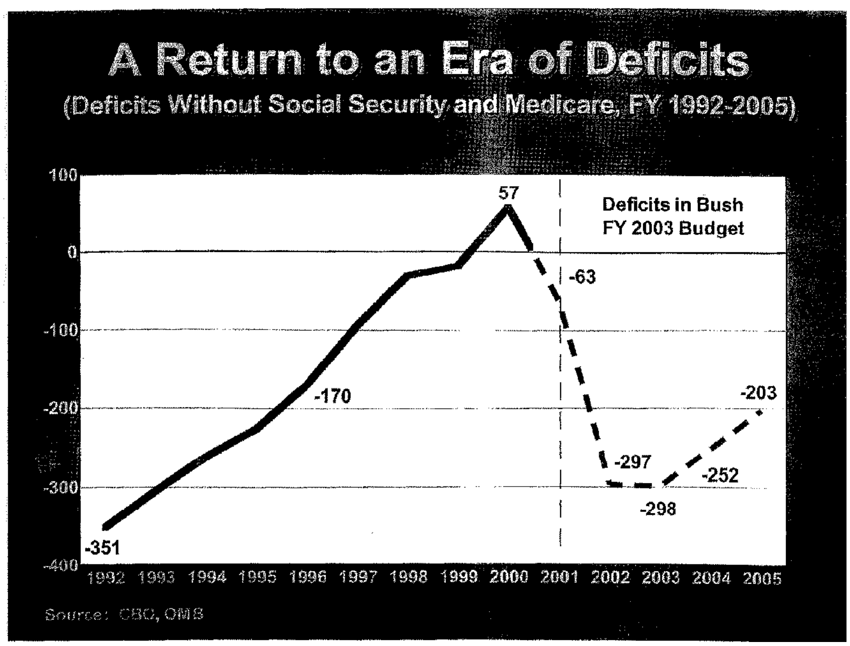
January 2001 versus January 2002 CBO Baseline, FY 2002-2011



The President said in his most recent State of the Union that, “Our budget will run a deficit that will be small in short-term.” USA Today pointed out that that is simply not the case. It is not going to be small and short-term. Instead, it is going to be large deficits and over a very extended period, and that is what the next chart shows very clearly, that we now face a decade of red ink.



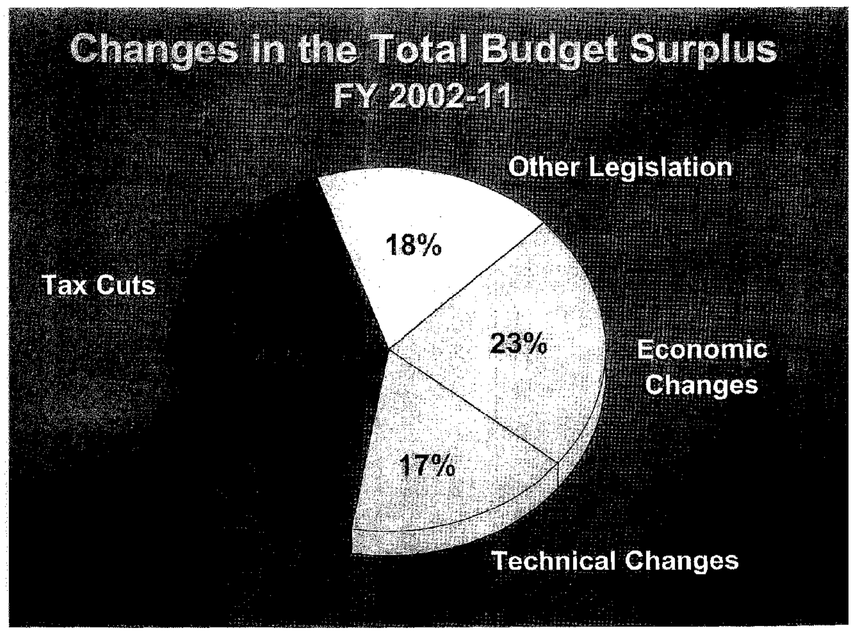
We, after a lot of effort by many different people, were able to emerge from a long period of deficits and at the end of the 1990's go into surplus, and we were headed for substantial surpluses, and now we have been plunged back into deficit.



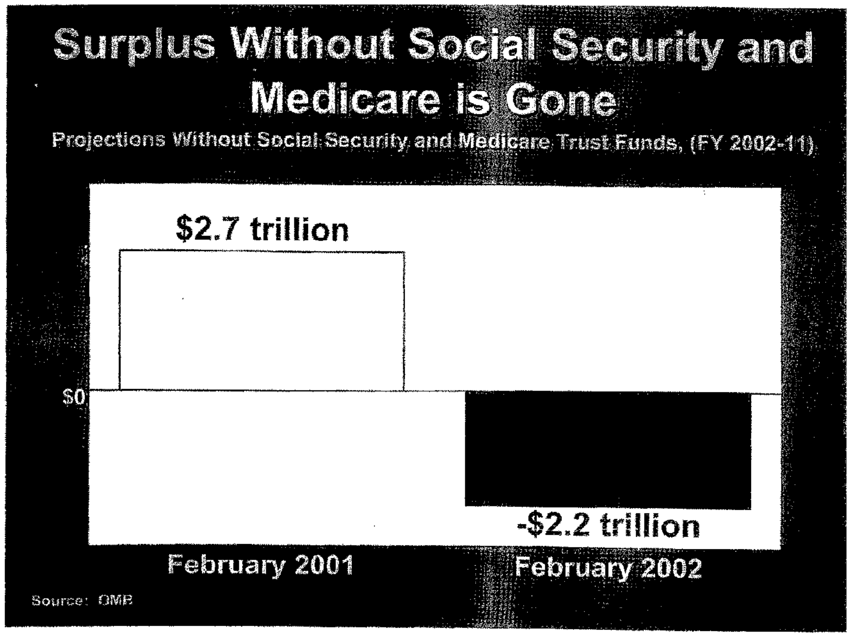
And the President says the reason is recession and war, and, of course, in the near term, he is correct. For this year and next year, the biggest reason is recession and war.

But over the decade, the biggest reason is something he is reluctant to talk about. The biggest reason over the next decade for our returns to deficit and debt is because of the tax cut the President proposed and pushed through Congress last year.

In fact, CBO testified that over the next decade, 42 percent of the disappearance of the surpluses is due to the tax cut, 23 percent is due to the economic downturn, 18 percent additional spending that came largely as a result of the attacks on this country on September 11th, 17 percent technical changes, largely underestimations of the cost of Medicare and Medicaid.



Let me just go to the last chart, which shows the results of all this. The result is that the total trust fund surpluses used for tax cuts and other spending programs will total nearly $2.2 trillion over the next decade, $1.65 trillion will be taken from the Social Security Trust Funds and $523 billion from the Medicare Trust Funds to pay for tax cuts and the other expenses of the Federal Government.



Some of us believe that is a profound mistake, given the fact the baby-boom generation starts to retire in just 6 years.

Today we have the opportunity to hear testimony from outside budget experts. Jack Lew, who is currently the Executive Vice President for Operations at New York University, was President Clinton's last Budget Director and someone who enjoyed very high credibility on both sides of the aisle in both chambers. He presided over the budget during a period when the fruits of fiscal discipline practiced during the 1990's were realized, when the budget turned from deficit to surplus, and when we began to pay down the public debt instead of adding to it.

Robert Bixby is the Executive Director of The Concord Coalition, which has a very strong record of advocating and defending fiscal discipline.

We welcome you both. I very much look forward to your testimony, and we will proceed with Mr. Lew.

STATEMENT OF JACOB J. LEW, EXECUTIVE VICE PRESIDENT FOR OPERATIONS, DESIGNATE, NEW YORK UNIVERSITY

Mr. LEW. Thank you, Mr. Chairman. It is a pleasure to be here with you today, and I want to join you in wishing my good friend, Senator Domenici, a quick recovery. We are all together hoping that he is going to be better very soon.

I appear today for the first time as a private citizen, and the views I express are accordingly my own. I also learned over the weekend, sitting there with my hand calculator, how much I appreciated the very good work of the OMB career staff over the last 6 years.

It is important to remember that deliberate policy choices were necessary to produce a surplus and begin to pay down the public debt. Similarly, deliberate policy choices in the budget presented this week chart a course in a very different direction.

Budget projections changed dramatically over the course of the Clinton administration. At the end of 1992, there was an annual deficit of $290 billion that was projected to rise to $639 billion by 2003. Fiscal discipline, starting in 1990 with the Budget Enforcement Act, continuing through 1993 and the Balanced Budget Act of 1997, really made a difference. Markets responded with low interest rates; growth only accelerated the accumulation of a surplus. As a result, during the time that I was OMB Director, we were able to pay off $363 billion in debt. That is an accomplishment that would have been called impossible if you predicted it in 1992, and we were actually on a path toward eliminating the publicly held debt.

A year ago, both the OMB and CBO projections showed that there would be a $5.6 trillion surplus over 10 years. There was broad consensus that there was sufficient resources to pay for a wide variety of initiatives and leave a cushion for the unexpected. The budget presented this week shows how quickly a surplus can be dissipated.

Much has changed over the past year: the recession was deeper than expected; there was an attack on September 11th that caused the need for additional spending; and there were specific policy changes enacted into law, which you mentioned in your opening remarks.

I think the trend from last year through this year really must be distinguished from the longer-term trend, as you noted. In 2002, instead of posting a surplus of $277 billion, there was a deficit of $106 billion. In 2003, the baseline shows that the surplus will drop from $307 billion to $51 billion. And with the policy proposals, it would go down to a deficit of $80 billion.

This is a very dramatic swing. One could raise questions about some of the need for provisions that are proposed for the next couple of years, particularly given the timing of them taking effect, the likely timing of a recovery, and the relatively poor targeting of some of them. But, nonetheless, I think that most budget analysts would agree that a tax cut in this short-term period does not mark a deviation from fiscal discipline. The unexpected did happen, and for those of us who oppose a balanced budget amendment to the Constitution, this was precisely the kind of circumstance where we expected that there might be a need to go back into deficit, war, recession, and the like.

Far more troubling is the steady drift away from fiscal policy, well beyond the economic recovery. And while the administration proposes that the baseline surplus will shrink to $2.2 trillion over 10 years, as you noted in your opening remarks, CBO shows it coming down to $1.6 trillion. And with the difference in Medicare accounted for, it gets $300 billion smaller. When you add in the administration's policy changes, the surplus over the next 10 years is virtually gone.

Neither the economic downturn nor military and domestic responses to September 11th really are sufficient to explain the longer-term trend. The single largest cause of the 10-year decline in the surplus is the tax cut enacted last year. I have looked at it using CBO numbers, which were a little bit different than the numbers you used, but they tell the same story. From 2002 through 2011 the tax bill costs $1.5 trillion, including interest costs. This budget proposes adding $600 billion of additional costs, bringing the total to well over $2 trillion between 2002 and 2012. In comparison, the administration's estimate of the increased spending for defense and homeland security over 10 years is $627 billion. So, clearly, the largest change in policy that has contributed to the shrinking of the surplus is the tax cut.

The change in fiscal condition is even more dramatic when Social Security is separated from the rest of the budget. CBO projects that the unified budget, including Social Security, goes back into surplus, the baseline goes back into surplus in 2004. But it is only because of the implicit assumption that Social Security funds will be available to support a deficit in the non-Social Security budget. The non-Social Security budget remains in deficit until 2009 in the CBO baseline, and the administration then proposes further spending and further tax cuts, which further draw down the surplus and drive up the non-Social Security deficit.

Under the administration budget, the non-Social Security budget remains in deficit for every year in the 10-year window. In 2008, the year when the baby boom begins to retire, the non-Social Security budget will be drawing $143 billion from Social Security to finance current operations of Government. At the end of the forecast period, the annual non-Social Security deficit is still $75 billion. And, cumulatively, as you noted in your opening remarks, the publicly held debt remains very high. It doesn't fall below $3 trillion until 2010 with the policy the administration proposes.

Dependence on the Social Security surplus to finance non-Social Security expenses is a dangerous but familiar pattern. It is the pattern that from 1981 through the early 1990's led to high interest rates and constrained economic growth. It led citizens to worry whether their Social Security benefits would be paid when they retired.

There is a sharp contrast to the virtuous cycle of the late 1990's when declining debt meant declining interest payments and only accelerated the buildup of the surplus and we were able to pay down the debt.

When the baby boom begins to retire in 2008, it will not be possible any longer to finance the non-Social Security budget out of a Social Security surplus. After 2016, the Social Security Trust Fund will first draw down the interest that is due it for past financing of non-Social Security expenses, and then it will need the principal just to pay the benefits as assumed in current law. This will only be possible if the non-Social Security budget is balanced and runs a surplus at that time. Unfortunately, the administration budget takes a path that makes it a distant memory to save the Social Security surplus and pay down the debt.

I would like to note a number of areas where the budget, I think, understates the extent of the problem. On the domestic discretionary side, there is—a little more than $200 billion of savings assumed in non-defense discretionary spending over 10 years. That is a very significant reduction below an inflated baseline, and it means that programs like education, health, biomedical research would all be under intense pressure. There is also an assumption that savings will be garnered from reducing programs, including the highway trust fund, where I think a lot of us are skeptical that the savings will really materialize. In the event the savings don't materialize, it only puts more pressure on non-defense spending.

In the tax area, while many of the tax provisions from last year's tax bill are extended, a number are not, and one in particular, the alternative minimum tax, is likely to cause extreme pressure on the system as millions and millions of middle-class taxpayers are forced into the alternative minimum tax after 2010. We have noted the Medicare baseline difference between the Congressional Budget Office and OMB. There also appear to be policy assumptions in here on Medicare which I personally am skeptical about, having seen the reaction to the Balanced Budget Act in 1997. The budget assumes that continued pressure on physician reimbursement and teaching hospital reimbursement will be successful. I don't think it is good policy at this point given the other strains on the system, and it is not very likely to be materialized.

I will conclude just by noting that there is broad support for a number of important policies, including defense increases and a prescription drug program in Medicare. Unfortunately, the administration's tax policy leaves virtually no room to fund other priorities. The choices seem fairly straightforward to me: domestic priorities can be severely reduced; the Social Security Trust Fund, contrary to promises made, can be used to finance these activities; or provisions of the tax bill that have not yet taken effect can be deferred until we can afford them.

At a time when there is increased understanding of the importance of clear financial projections, the integrity of a budget requires more than simple arithmetic. A budget must accurately detail the demand for Government services and the likely sources of revenue. While this budget paints a grim fiscal picture, it understates the true extent of the problem, and I believe it misstates the cause, which is not a war but tax policy.

Mr. Chairman, I would conclude my remarks there and would welcome any questions that you have. Thank you.

[The prepared statement of Mr. Lew follows:]

THE PREPARED STATEMENT OF JACOB J. LEW

Thank you for inviting me to testify this morning. As Director and Deputy Director of the Office of Management and Budget, I appeared before this Committee many times, but today I appear for the first time as a private citizen, and the views I express are accordingly my own. It is also the first time I have prepared testimony for this Committee without the able assistance of the OMB career staff, which only heightens my appreciation for their outstanding service.

It is important to remember that deliberate policy choices were necessary to produce a surplus and begin to pay down the public debt. Similarly, deliberate policy choices in the budget presented this week chart a path in a very different direction.

Budget projections changed dramatically from the beginning to the end of the Clinton administration. At the end of fiscal year 1992, the annual deficit was $290 billion and it was projected to rise to $390 billion in fiscal year 1998 and $639 billion in fiscal year 2003. Fiscal discipline, starting with the Budget Enforcement Act of 1990 and continuing with deficit reduction legislation in 1993 and the Balanced Budget Act of 1997, reversed twenty years of ballooning deficits. Markets responded with low interest rates which helped drive strong economic growth and accelerated the accumulation of a surplus. As a result, during my 3 years as Director of the Office of Management and Budget we were able to pay off $363 billion in debt, an accomplishment that would have been called impossible if predicted in 1992. We were on a path toward eliminating the publicly held debt.

Last January I appeared here on the last full day of the Clinton administration to present our final baseline budget projections. At that time, the Office of Management and Budget and the Congressional Budget Office both projected a 10-year surplus of $5.6 trillion. The debate was whether it would be possible to eliminate the entire debt held by the public within 10 years or whether even with a surplus some debt could simply not be paid off. There was broad consensus that the projected surplus would both accommodate substantial new policy initiatives and provide a cushion against potential unexpected shocks. The budget presented this week includes a simple table that shows in black and white how quickly a surplus can be dissipated. According to Administration estimates, the baseline surplus has dropped to $2.2 trillion and the proposed budget would reduce it further to only $665 billion over the same period.

Much has changed over the past year: the recession was deeper than expected; terrorist attacks on the World Trade Center and the Pentagon required a substantial commitment of new resources for defense and domestic security; and policy changes, in particular a significant tax cut, were enacted into law. To understand the change that has taken place and chart a path back to fiscal discipline, it is crucial to differentiate the impact of economic conditions, attacks that could not be predicted and policy changes that were deliberate decisions. The trend from last year through this year must be distinguished from the longer term trend. In 2002, instead of posting a surplus of $277 billion, there was actually a deficit of $106 billion. In fiscal year 2003, instead of a surplus of $307 billion, as projected last year, the current baseline shows a surplus of $51 billion. If the Administration's proposals are enacted, the 2003 deficit will be $80 billion.

This is a dramatic swing, and one could question whether additional economic stimulus is likely to have a positive effect before a recovery is already underway, particularly if the stimulus is not targeted well. Nonetheless, in the context of an economic downturn along with significant military and emergency expenses, a deficit in these years does not indicate a radical departure from fiscal discipline. In fact, the key argument against a constitutional amendment to balance the budget has always been the need to respond to unexpected and unpredictable events such as war and economic recession. Far more troubling is the forecast of a steady drift away from fiscal discipline, well beyond the economic recovery, which the budget presented this week only accelerates. While Administration projections show the baseline surplus over 10 years shrinking to $2.2 trillion, the Congressional Budget Office is even more pessimistic, forecasting a baseline surplus of only $1.6 trillion. One difference between the two forecasts that jumps out is Medicare spending, where CBO assumes over $300 billion of additional spending under current law. If CBO is correct, the Administration estimate of $665 billion remaining surplus over 10 years would be almost completely erased.

Neither the economic downturn nor the military and domestic response to the September 11 attacks on the World Trade Center and the Pentagon are sufficient to explain this longer term trend. In fact, the single largest cause of the 10-year decline in the surplus is last year's tax bill. From 2002 through 2011 the tax bill will cost $1.5 trillion, including higher interest costs due to the larger national debt resulting from the tax cut. In the current budget, the Administration proposes additional tax cuts, including an extension of provisions that were set to expire under last year's tax bill, adding over $600 billion in additional cost. This brings the cost of the tax bill to more than $2 trillion between 2002 and 2012. In contrast, the proposed increase for defense and homeland security from 2003 through 2012 is $627 billion.

The change in fiscal condition is even more dramatic when Social Security is separated from the rest of the budget. CBO projects that the unified budget, including Social Security, will return to surplus in 2004, but only because of the implicit assumption that the Social Security surplus will be used to finance non-social security tax and spending policies. The CBO baseline projects that the non-social security budget remains in deficit until 2009 and over 10 years projects a non-social security deficit of $742 billion. The Administration budget proposals would further reduce revenue and increase spending at the same time, driving the non-social security deficit to $1.7 trillion between 2002 and 2012.

In fact, under the Administration budget the non-social security budget remains in deficit for the entire period. In 2008, the year when the baby boom begins to retire, the non-social security budget will continue to draw $143 billion in financing from the Social Security Trust Fund. At the end of the forecast period, the annual non-social security deficit would still be $75 billion. Cumulatively, shifting from a policy of saving the Social Security surplus and using it to pay down debt means that the publicly held debt will remain quite high, around $3 trillion throughout this period. Administration projections show that the publicly held debt will not fall below $3 trillion until 2010. Consequently, interest payments instead of falling to near zero, will remain in the range of $150 billion a year even at the end of the 10-years.

Dependence on the Social Security surplus to finance non-social security expenses is a dangerous but familiar pattern. It is the path that from 1981 through the early 1990's led to high interest rates and constrained growth. It is also the path that led citizens to worry about the ability of the Federal Government to make payments for Social Security and other entitlements when the baby boom retires. Stubbornly high long-term interest rates today suggest that the financial community expects Federal borrowing to remain heavy for some time to come.

We enjoyed a virtuous cycle in the late 1990's, as declining deficits permitted the repayment of debt and a further decline in interest costs. The non-social security budget no longer depended on Social Security financing to run a surplus and Federal outlays for. interest payments were rapidly shrinking.

When the baby boom begins to retire in 2008, it will no longer be possible to finance the non-social security deficit from the trust fund. Starting in 2016, only 8 years later, in order to pay current benefits the Social Security Trust Fund will first spend the interest and eventually the principal, it is owed for past financing of general government expenses. This will only be possible if the non-social security budget can be balanced and eventually run a surplus. Unfortunately, the Administration budget takes a path which makes a distant memory the goal of saving the Social Security surplus to pay down the debt and protect Social Security.

In a number of areas, this budget understates the true extent of the problem. For example, it assumes non-defense-spending cuts that appear unrealistic. After accounting for increases in homeland security, all other discretionary spending will be reduced by more than $200 billion over 10 years compared to the baseline, which keeps pace with inflation. Moreover, if specific proposals to reduce spending are rejected, such as the proposal to reduce spending from the highway trust fund, the cut to all other discretionary spending will only get deeper. With broad bipartisan support for education funding, biomedical research and other important domestic priorities, it is difficult to see how such deep reductions can or should be achieved. Yet if savings fail to materialize, the fiscal problem will only get more severe.

On the tax side, the budget does not address issues that are likely to become increasingly troubling. For example, it does not recognize the fact that the individual alternative minimum tax, through a form of bracket creep, will cover tens of millions of middle income taxpayers over the coming years. In fact, the cost of the Administration's own tax cuts is reduced because of the assumption that the AMT will force more and more middle income taxpayers to give up some of their rate cuts through this back door. Tax experts agree that the individual AMT should be modified, but this budget does not leave room for the cost associated with such a change.

As noted above, the budget forecasts a rate of Medicare spending which may be $300 billion too low if CBO is correct in its projections. Moreover, the Medicare proposals appear to count on continued savings from provisions that tightly limit reimbursement to physicians and teaching hospitals. In recent years, Congress has demonstrated on a bipartisan basis that these limits were too tight. At a minimum, funding for prescription drug coverage appears to be dependent on continuing these savings.

There is also a distressing trend toward triggers that make spending and tax cuts appear to go away. As we see in this budget, policies that are assumed to disappear have a way of coming back.

There appears to be broad support for a number of important policies, including increased defense spending and prescription drug coverage under Medicare. There should be sufficient surplus available to finance these investments without going back to deficit spending. Unfortunately, the Administration's tax policy leaves virtually no room to fund other priorities. The choices are actually pretty straightforward: domestic priorities can be severely reduced; the Social Security Trust Fund, contrary to promises made, can be used to finance these activities; or provisions of the tax bill that have not yet taken effect can be deferred or reconsidered.

At a time when there is increased understanding of the importance of clear financial presentations, the integrity of a budget requires more than simple arithmetic, A budget must accurately detail demand for government services and likely sources of revenue. While this budget paints a grim fiscal picture, it understates the true extent of the problem. It also misstates the cause, which is not war but a tax policy that we cannot afford without turning away from the goal of protecting the Social Security surplus and paying down the debt.

Chairman CONRAD. Thank you very much, Mr. Lew. Thank you for that excellent, thoughtful testimony.

Mr. Bixby, welcome. Good to have you here and please proceed with your testimony.

STATEMENT OF ROBERT L. BIXBY, EXECUTIVE DIRECTOR, THE CONCORD COALITION

Mr. BIXBY. Thank you very much, Mr. Chairman, and I, too, would join in wishing Senator Domenici a speedy recovery and hope that he is back with the committee very soon. He has been a good friend to balanced budgets and to The Concord Coalition and to the cause of fiscal discipline.

I am here representing The Concord Coalition, which is a bipartisan organization dedicated to strengthening the Nation's long-term economic prospects through prudent fiscal policy, and our organization is chaired by two of your former colleagues: Senator Warren Rudman, a Republican of New Hampshire, and Senator Bob Kerrey, Democrat of Nebraska.

The President's budget message identifies five overall priorities: protecting the homeland, winning the war against terrorism, funding initiatives while moderating the growth in spending, returning to economic vitality. These are all worthy objectives, but to that list, The Concord Coalition would add a sixth critical objective: addressing the unsustainable long-term fiscal challenge of our aging population. With the first of the boomers qualifying for both Social Security and Medicare within the coming decade, The Concord Coalition strongly believes that the long-term challenge is, by itself, a short-term concern.

Now, the short-term context in which this budget is presented by the President has changed in many different ways that were noted by Jack Lew and also by yourself, Mr. Chairman. Suffice it to say that we are in a new environment having to deal with a war against terrorism at home and abroad and a recession. These are things that we did not have to deal with. So it is not surprising that the budget—that there would be fiscal consequences to that.

But, nevertheless, the numbers do demonstrate a startling turnaround. Not only the overall budget surplus is being declined, but the fact that the non-Social Security surplus has frankly disappeared over the 10-year period, we were looking at a post-policy non-Social Security surplus, a reserve fund, if you will, in last year's budget of $840 billion or so. And the non-Social Security deficit is now $1.6 trillion over that same 10-year period. So that is a very significant swing, and it has serious consequences for the budget as we make these long-term plans.

That having been said, The Concord Coalition is as strong an advocate of balanced budgets as there is. We recognize, however, that there may be times when a deficit is an appropriate response to pressing national needs. Fiscal years 2002 and 2003 may fit that description. But the temporary need to run a deficit should not be taken as an excuse to abandon fiscal discipline, which is still needed to help prepare for the long-term challenges.

In other words, the problem now is we don't want to dig such a large hole that it will be impossible to climb back out of before the baby boomers leave the work force and begin to cash in the trust fund IOUs for Social Security and Medicare. That is not a new bill that we have to pay, but one that we are already on the hook for.

With that observation, let me turn to some of the policy prescriptions in the President's budget.

First of all, there is obviously a big increase for defense spending. I think that given the circumstances, that is not too surprising.

One caveat I would like to point out, it is possible that it may even be understated. If the extent of the effort is as long and as extensive as the President seems to indicate—and, you know, he has been pretty forthright about the fact that this is not going to be a short effort—it could be that the levels of spending for defense over the coming decade will actually be larger than these budget forecasts indicate.

Looking at defense spending as a percentage of the economy, in the budget it pretty much keeps pace with the economy. Not so long ago, defense spending as a percentage of the economy was considerably higher, as early as the early 1990's when we were fighting the Gulf War. So while there is certainly a big defense here, I just want to lay out that as a possible caveat, that we need to be ready that there may be more coming.

On the non-defense discretionary side of the budget, I think that the assumption here is clearly unrealistically low. I would agree with the administration that there is a need, given the short-term demands, to scrutinize the budget as carefully as possible and perhaps hold non-defense discretionary spending as low as possible in the current year or two, particularly as we also increase homeland security expenditures.

But making an assumption that one can hold non-defense discretionary spending to a level that is below 2 percent growth for the fiscal years beyond 2004 is not just optimistic, it is wildly optimistic. I just don't think that is going to be done. And the problem with that is that it does produce in the baseline presumed savings that will never happen.

I think back to the days when we used to do balanced budget plans, 5-year balanced budget plans, which we may have to start doing again. And they would always follow a similar path. They would go up in the first year or two, and then you would have a steep drop in years three, four, five, and that is where all the savings were. And if you look at the path of non-defense discretionary spending in the President's budget, that is the path that it follows.

Economic stimulus. I would be just as happy if you didn't bother with that. I mean, we all want a strong economy, but an awful lot of fiscal stimulus is already in the pipeline through last year's tax cuts. I think the Republicans should claim credit for those tax cuts and say this was very well timed, and we probably don't need to do any more right now. There is a lot of new spending in the pipeline, so you look at the budget numbers, and it may just be that the fiscal stimulus bill that people are, for understandable reasons, wanting to do, may end up being unnecessary. But it would knock a hole in the budget in the next couple of years.

The Concord Coalition feels similarly about long-term tax cuts. There are a lot more tax cuts in the President's budget, some $600 billion or so, probably best to leave those alone. I think that given the uncertainties on the war effort and how much that is going to cost, given the fact that a large tax increase is already in place—excuse me, a large tax cut is already in place, and the fact that the budget surpluses were back into spending the Social Security surpluses, it would be best not to enact any new tax cuts at this time. That includes extending the—or removing the sunset provision from last year's tax cut. Clearly, that is an issue that is going to have to be addressed at some point. It makes the baseline sort of skewed because you get huge surpluses in the last couple of years. So I don't think you should rely on a sunsetted baseline to make your policy decisions this year, but I don't think the sunset should be removed at this point because we just don't know what resources we are going to need out beyond those 10 years. And as we look forward, if the deficits are long-lasting and deep, then we certainly will want to revisit those tax cuts. So it is probably best to leave the trigger—leave that in place as the ultimate trigger right now.

Let me close by making a comment about the Social Security firewall. One of the most disturbing things about the budget and what has happened here is that that Social Security fiscal firewall has come down. Before September 11th, that was the strongest fiscal firewall there was. It was stronger than caps or pay-go or anything else, because it really has some political bite to it. I used to be field director for The Concord Coalition, and I can tell you that you go out and talk to people, you do radio call-in shows or whatever. There is one thing that Democrats and Republicans alike and the public is quite clear on, and that is that they do want the Social Security surplus saved and not used to fund other operations of Government.

Now, for understandable reasons, we can't do that this year. Probably next year—it is going to take a while to climb back up to that goal. But we shouldn't abandon the goal altogether, and the President's budget implicitly does that because throughout the 10-year period, we never back into an on-budget surplus. So speaking of 5-year balanced budget plans, it might not be a bad idea to look at what it would take to get us back to an on-budget surplus, a new balanced budget plan using our agreed-upon definition of what the new balanced budget would be. And in that regard, everything really needs to be on the table.

But the President's budget presents a clear choice in that regard. You can either do the tax cuts that have been enacted and the new spending that people want to do, or spend the Social Security surplus. I mean, something has to give in there. The President's budget is saying you can't do it all. And so whether it is this year or next year, or whenever, at some point everything needs to be put on the table to see if we can get back into that Social Security surplus.

That to me is the most important thing about this. The mix of policy options is something that the Congress will come up with in the usual course of negotiations. But I think the most fundamental thing is we need to re-establish and reaffirm that goal and figure out a plan for getting back to achieve it, because the ultimate thing here is while we have lots of new problems that have come up over the past year, nothing has changed about the old problems. The boomers' retirement—when you and I reach retirement age, Mr. Chairman, and Jack Lew, too, those that come after us have already got a big bill coming due. And everything we can do now to increase savings in anticipation of that we should be doing.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Bixby follows:]

THE PREPARED STATEMENT OF ROBERT BIXBY

Mr. Chairman, Senator Domenici, and members of the Committee, thank you for inviting me to appear today to discuss the President's Fiscal Year 2003 budget. I am here representing The Concord Coalition, a bipartisan organization dedicated to strengthening the Nation's long-term economic prospects through prudent fiscal policy. Concord's co-chairs are former Senators, Warren Rudman (R–NH) and Bob Kerrey (D–NE).

My testimony today will review the President's budget in light of the many new security and economic challenges presented over the past year and the familiar long-term fiscal challenges that loom just beyond the current 10-year budget window as the huge baby boom generation enters its retirement years. I will also discuss five policy guidelines recommended by The Concord Coalition to help ensure that the long-term fiscal health of our Nation is not sacrificed to short-term concerns.

The President's Budget Message identifies five overall priorities: protecting the homeland, winning the war on terrorism abroad, returning to economic vitality, governing with accountability and funding other initiatives while moderating the growth in spending. These are worthy objectives. But to this list, The Concord Coalition would add a sixth critical objective: addressing the unsustainable long-term fiscal challenge of our aging population. With the first of the boomers qualifying for both Social Security and Medicare within the coming decade, The Concord Coalition strongly believes that the long-term challenge is, by itself, a short-term concern.

I. THE SHORT-TERM CONTEXT: A DRAMATIC CHANGE

President Bush's Fiscal Year 2003 budget is presented in a short-term context that is far different from presidential budgets in recent years:

- We have embarked upon a worthy, but costly, effort to defeat the worldwide terrorist network that launched a deadly attack on our Nation last September.
- We have come to recognize the need to substantially increase spending on homeland security.
- We are in an economic recession for the first time in 10 years.
- We have enacted a series of escalating tax reductions over the next decade that will reduce revenues and increase debt service costs by an estimated $1.7 trillion.
- As a result of the above factors, the huge surpluses, which were projected just a year ago, have been diminished by about 70 percent
- The non-Social Security surplus has vanished, and for the first time in many years there is no clear, agreed upon fiscal policy goal to constrain spending increases and tax cuts.
- The budgetary enforcement mechanisms, caps on discretionary spending and the pay-as-you-go requirement for tax cuts and entitlement spending, no longer apply.

The President's budget, like the January 2002 report of the Congressional Budget Office (CBO), clearly demonstrates the rapid decline in the government's fiscal position over the past year. Deficit spending will return this year for the first time since 1997, and continue through 2004 assuming enactment of the President's policies.

The numbers demonstrate a startling turnaround:

- Last year the President's budget projected that even with enactment of his recommended tax cut and other policy priorities there would be a 10-year budget surplus of $3.4 trillion—enough to eliminate the debt held by the public. This year's budget, assuming enactment of the President's policies, projects a surplus ofjust $665 billion over the same 10-year timeframe.
- Last year the President's budget showed a 10-year non-Social Security surplus of $841 billion. This year's 10-year projection is for a non-Social Security deficit of about $1.6 trillion over the same period (Fiscal Year 2002–2011).

- In last year's budget, non-Social Security surpluses were projected for every year. In the current budget, the opposite is true. There is no year in which a non-Social Security surplus is projected.

The policy initiatives in the President's budget respond to the challenges of the new environment. As the President notes, the government "will have new bills to pay." These new costs, plus the proposed new tax cuts in the President's budget, are expected to produce deficits for the next couple of years. If so, they would be the first Federal budget deficits since 1997.

The Concord Coalition is as strong an advocate of balanced budgets as there is. We recognize, however, that there are times when a deficit is an appropriate response to pressing national needs. This may well be true in fiscal year 2002 and perhaps 2003. But the temporary need to deficit spend should not be taken as an excuse to abandon fiscal discipline, which is still needed to prepare for the long-term challenges. We should not dig such a large hole now that it will be impossible to climb back out of it before the baby boomers begin to leave the work force and qualify for Social Security and Medicare. That is not a "new bill," but one we are already on the hook for.

With that observation, let me turn to some of the policy prescriptions in the President's budget. These will be general observations given the short time that has passed since the budget documents were published.

Defense increase

The President's proposed increase in defense spending represents a substantial increase over the budgets of recent years. This is not surprising given that we are now engaged in an ambitious and worthy effort to defeat worldwide terrorism. Simply put, the peace dividend, which helped to control total discretionary spending in the 1990's, is over.

Large as the defense increase may appear it is relevant to note that according to OMB tables, defense spending as a percentage of GDP would essentially remain constant at about 3.4 percent over the next 5 years. As a point of comparison, defense spending was at 5.4 percent of GDP in 1991 when we were preparing for and fighting the Persian Gulf War. If the current war effort expands, the level of spending projected in the President's budget may well prove to be a down payment on even larger increases. In a time of such uncertainty, this possibility cannot be lightly ignored.

Non-defense discretionary spending

This category includes homeland security, which deservedly gets a big boost in the President's budget. However, non-defense discretionary spending is assumed to grow at an average annual rate that is unrealistically low. After an initial increase of 6 percent in 2003 non-defense discretionary spending is assumed to grow at 3.2 percent in 2004 and by just 1.5 percent on average from 2004 to 2007. While the need to spend more on homeland security and defense should, as the President says, prompt a careful review of all other budgetary priorities, it is not prudent fiscal planning to assume large savings in the out years based on an assumption that future lawmakers will be able to achieve a level of fiscal restraint not achieved in the recent past. Baseline assumptions are highly dependent on the presumed growth of discretionary spending. Using an assumption that is too low will produce presumed budgetary resources that will never materialize. For example, if total discretionary spending grows at roughly the rate of GDP growth instead of the rate assumed in the President s budget it makes a difference of about $1 trillion over 10 years.

Economic stimulus

The President's budget leaves room for an economic stimulus package of $77 billion in Fiscal Year 2002, $57 billion in Fiscal Year 2003, and $141 billion over the new 5-year budget window (Fiscal Year 2003 through Fiscal Year 2007.)

What leaps out from the OMB documents is that without the economic stimulus proposal the budget would be very close to balance in Fiscal Year 2003 and would be in overall surplus again by Fiscal Year 2004. This raises a very real question as to whether you should postpone the idea of a major stimulus bill and thus avoid larger deficits, or go ahead with a stimulus bill on the assumption that the economy needs it to recover. In recent months the economy has shown promising signs of recovery. While there is reason to remain vigilant at this point there appears to be diminishing need for an economic stimulus bill designed to "fix" an economy that seems to be fixing itself.

If you do choose to go ahead with an economic stimulus bill, great care should be taken to front-load its cost and minimize the long-term budgetary drain. It is important to recognize that a great deal of fiscal stimulus is already in the pipeline.

The tax cut enacted in June and the new spending approved since September 11 will provide stimulus along with the "automatic stabilizers" in the budget. Moreover, this fiscal stimulus comes on top of the substantial monetary stimulus provided by the Federal Reserve Board since last January.

New tax cuts

The President's budget requests another $600 billion in new tax cuts over the next decade, including the stimulus package. The biggest initiative in this regard is his suggestion that the "sunset" provision of last year's tax bill be removed. This would make permanent all of the provisions scheduled to expire at the end of 2010.

Obviously, the sunset provision should not be taken literally. The very absurdity of the presumption written into last year's bill that all rates and other provisions of the tax code would revert to their 2001 status on midnight December 31, 2010, guarantees that it will never happen. The real significance of the provision is that it allowed lawmakers to temporarily avoid making hard choices about which tax cuts would have to be eliminated from the bill to fit within the carefully negotiated budget resolution limit of $1.35 trillion over 11 years.

But it also serves a useful purpose—it is the ultimate "trigger." At some point the cliff effect of last year's tax cut will have to be addressed. As events unfold over the next year or two, and we see whether deficits are as short and modest as the President hopes, it may make sense to adjust the tax cuts accordingly—perhaps extending some of them permanently while limiting or delaying the effect of others. For that reason, The Concord Coalition does not, at this time, believe it would be a good idea to remove the sunset from the tax cuts. However, if Congress chooses to maintain the sunset provisions it should ensure that new policies be assessed against a baseline that accounts for the tax cut as if the sunset provisions didn't exist. The fiction that the sunsets will take place as planned should not be indulged to justify new initiatives.

Regarding tax cuts, it should also be noted that the President's budget assumes that certain provisions of the tax code, referred to as "extenders," will not be renewed for the full 10-year window. This tends to overstate likely revenues. According to CBO extending all of the extenders for 10 years would cost $166 billion.

Moreover, there are some mini-sunsets in last year's tax bill that also artificially depress its cost estimate. For example, the Alternative Minimum Tax (AMT) provision, which costs $14 billion from 2001–2005, terminates at the end of 2004. A new above-theline deduction for higher education expenses is assumed to sunset after 2005. It is no more likely that these mini-sunsets will take effect than it is that the overall sunset will occur in 2010. And yet it does not appear that the President's budget includes the full cost of extending theses items, which according to the CBO would cost $194 billion over 10 years.

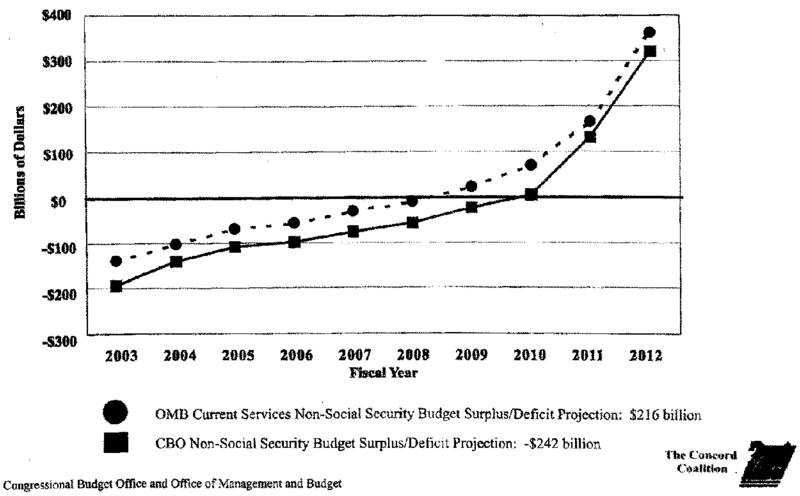
For purposes of comparison, the cost of extending all expiring tax provisions is estimated by CBO to be $735 billion, not including interest, over the next 10 years. The cost of extending expiring tax provisions in the President's budget is about $400 billion.

It is important to note that problems with the alternative minimum tax do not begin or end with last year's tax cuts. The AMT, which was designed to prevent wealthy taxpayers from using a combination of deductions and tax breaks to pay little or no income taxes, is not indexed for inflation. Over the years, the number of taxpayers subject to the AMT has been slowly increasing. But without reform, the number of taxpayers subjected to the AMT will shoot up from 1.4 million this year to 35.5 million in 2010. Last year's tax bill is responsible for about 15 million of these prospective new AMT ratepayers. As a result, a growing number of taxpayers will not receive the full amount of the tax cut they have been led to believe they will get. Given that the goal of the tax cut is to give money back to the taxpayers, it seems unlikely that Congress will take away with one hand what it gives back with the other. Correcting this problem through 2010 is estimated to cost about $200 billion according to the Joint Committee on Taxation. Even with this correction, the number of taxpayers subjected to the AMT will rise to over 20 million by 2011. Thus, it is likely that additional modifications will have to be made to address the AMT problem that already existed before the tax cut. The President's budget sets aside no resources to deal with this brewing problem.

With deficits back, and a large tax cut having been enacted last year based on surplus projections that were overly optimistic, The Concord Coalition strongly believes that this is not the year to engage in another round of major tax cuts. It's time to get back to the pay-as-you-go principle that was so useful in constraining the growth of deficits before escalating surplus projections eroded that discipline.

CBO 10-Year Total Budget Surplus/Deficit Projections versus OMB Current Services Baseline Projections

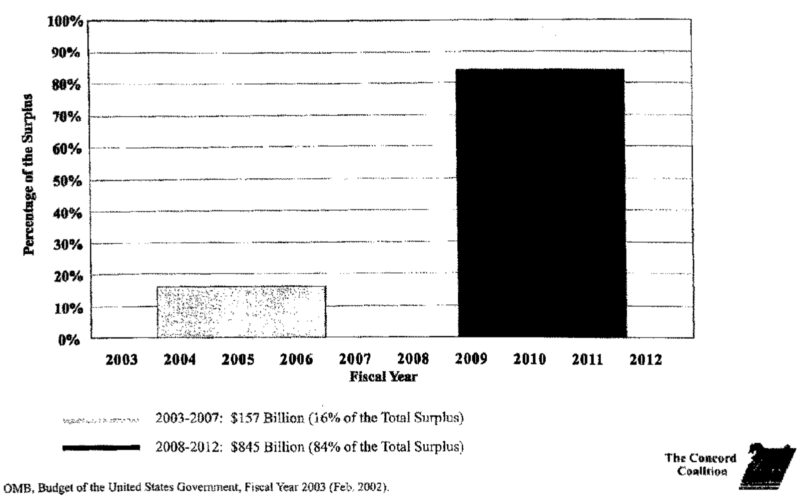
Fiscal Years 2003-2012



Source: Congressional Budget Office and Office of Management and Budget

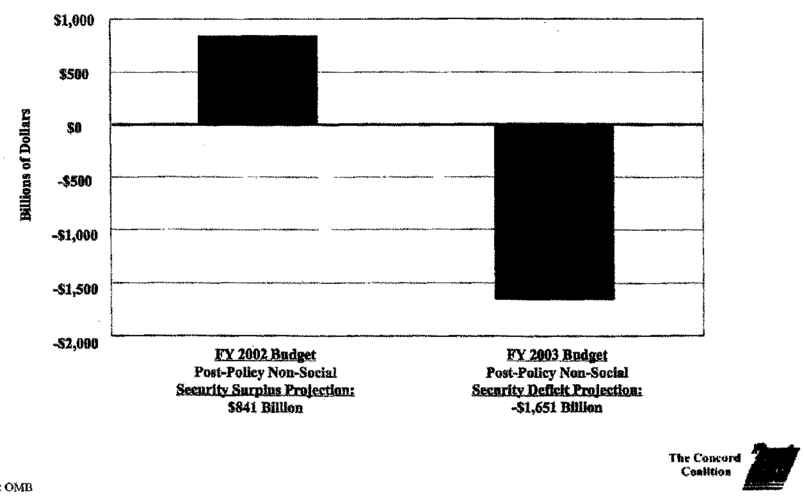
84 Percent of the Post-Policy Total Budget Surplus Comes in the Last 5 Years

Fiscal Years 2003-2012



Source: OMB, Budget of the United States Government, Fiscal Year 2003 (Feb. 2002).

Comparison of OMB Non-Social Security Surplus/Deficit Projections
Fiscal Years 2002-2011

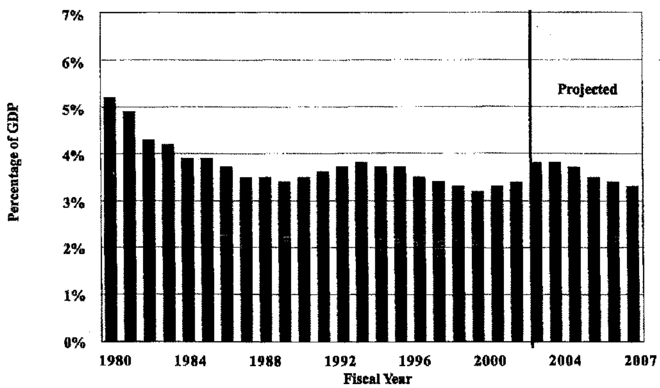


Source: OMB

Defense Spending as a Percentage of GDP
Fiscal Years 1980-2007

Source: OMB, Budget of the United States Government, Fiscal Year 2003 (Feb. 2002).

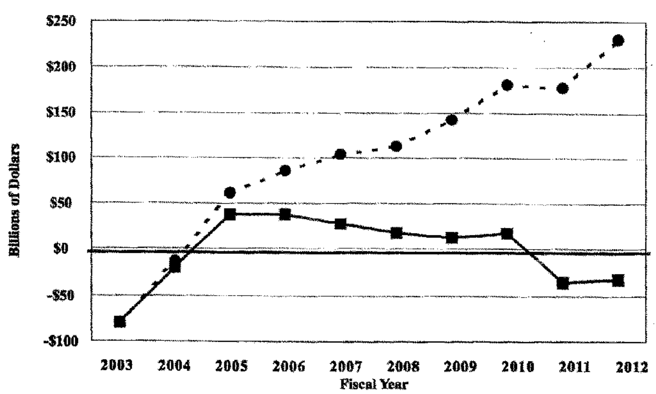
Non-Defense Spending as a Percentage of GDP
Fiscal Years 1980-2007



The Concord Coalition

Source: OMB, Budget of the United States Government, Fiscal Year 2003 (Feb. 2002).

Unified Budget Assuming Total Discretionary Spending Keeps Pace with Economic Growth
Fiscal Years 2003-2012



● OMB Post-Policy Baseline:
Unified Surplus: $1,002 billion (2003-2012)

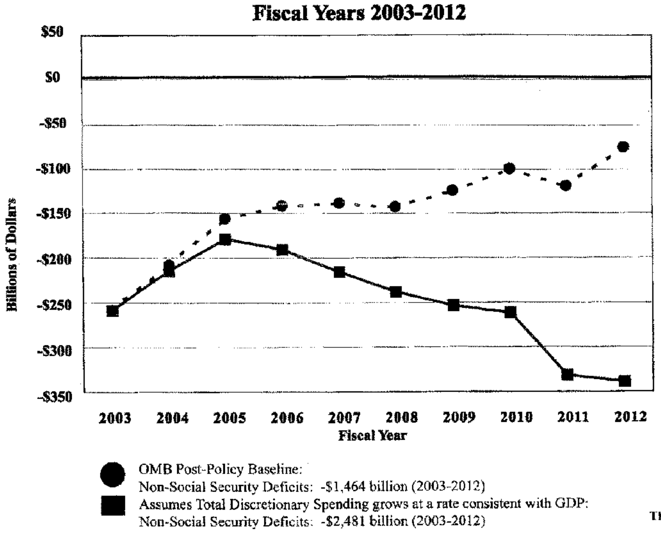
■ Assumes Total Discretionary Spending grows at a rate consistent with GDP:
Unified Deficit: -$15 billion (2003-2012)

The Concord Coalition

Source: OMB; Concord Coalition Analysis.

Non-Social Security Deficits Assuming Total Discretionary Spending Keeps Pace with Economic Growth

Fiscal Years 2003-2012

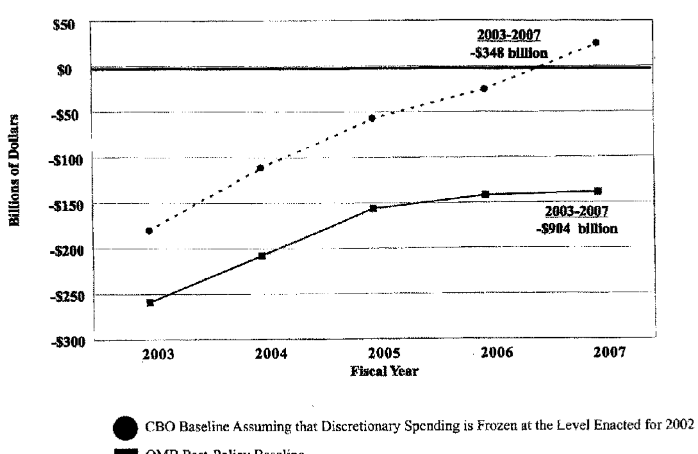


The Concord Coalition

Source: OMB; Concord Coalition Analysis.

A Discretionary Spending Freeze Would Not Produce a Non-Social Security Surplus Until 2007

Fiscal Years 2003-2007

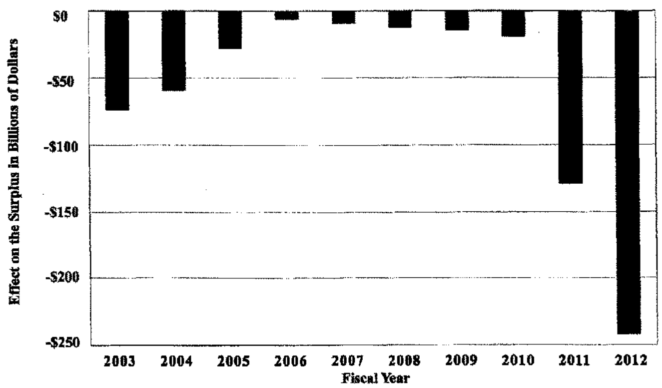


The Concord Coalition

Source: CBO, The Budget and Economic Outlook: Fiscal Years 2003-2012 (Jan. 2002); OMB, Budget of the United States Government, Fiscal Year 2003 (Feb. 2002).

The Tax Proposals in the President's Budget Have the Biggest Effect in the Last Two Years

Fiscal Years 2003-2012



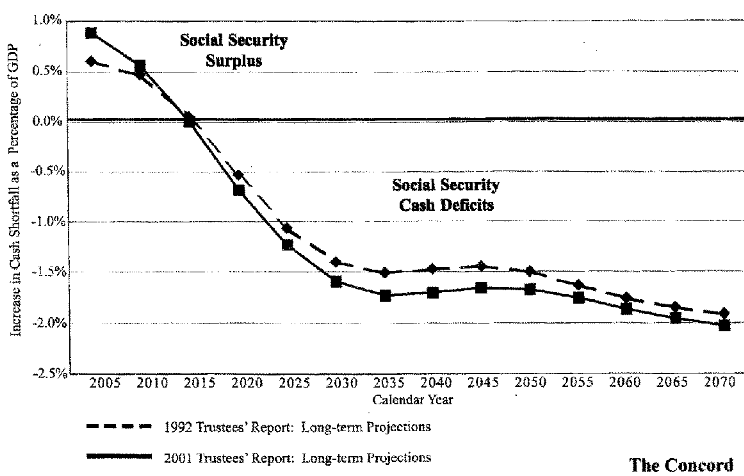
Enacting Proposed Tax Provisions would result in a $591 billion impact on the budget.

The Concord Coalition

Source: OMB

Ignoring the Inevitable:

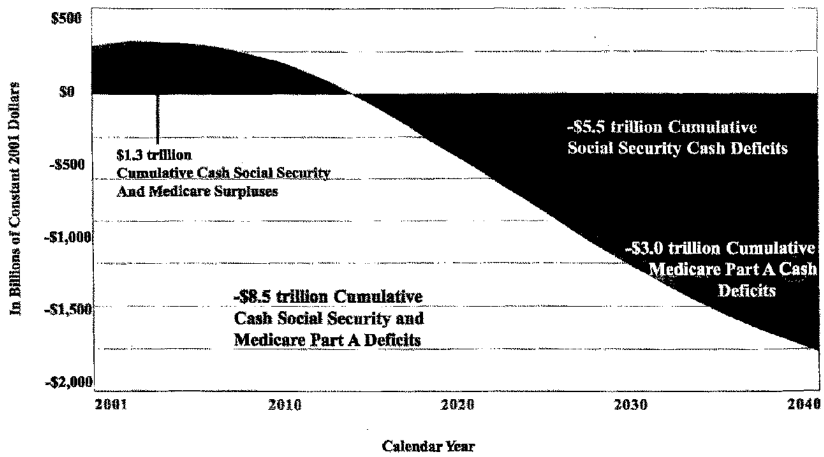
Despite the Economic Boom of the 1990's, Social Security's Long-Term Financing Gap has Actually Widened



The Concord Coalition

Source: Social Security Administration

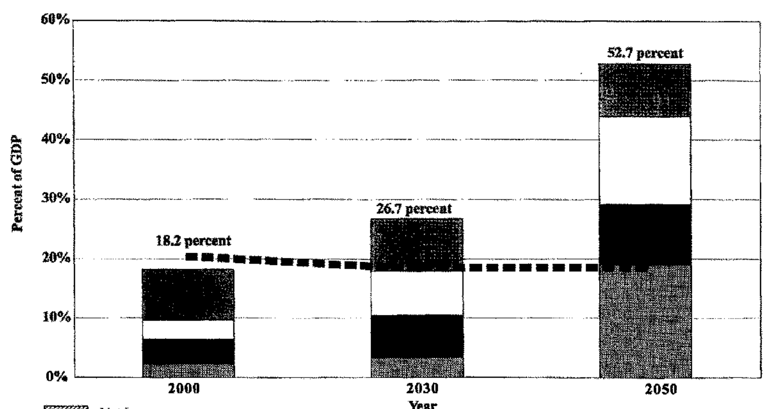
SOCIAL SECURITY AND MEDICARE PART A CUMULATIVE CASH DEFICITS IN CONSTANT 2001 DOLLARS 2001-2040



Source: Social Security Trustees' Report, March 2001 Intermediate Projections.

THE CONCORD COALITION

The Current Trend in Entitlement Spending is Unsustainable*



Net Interest
Social Security
Medicare & Medicaid
All Other Spending
Revenue

*Note: This chart reflects GAO's "Eliminate Unified Surpluses" simulation based on the CBO August 2001 baseline. In this simulation unified surpluses through 2011 are eliminated through permanent tax cuts and spending increases in equal proportions. Social Security, Medicare and Medicaid grow to such large shares of the economy [compared to what the actuaries project] partly because GDP growth slows dramatically as the deficits projected under this scenario subtract from national savings.

Source: General Accounting Office, August 2001.

The Concord Coalition

Chairman CONRAD. It was excellent testimony.

What I would like to do is kind of enter into a dialog here with you on the series of issues facing this committee as we attempt to write a budget resolution for the year.

Let me start with something that you mentioned, Mr. Bixby, and that Mr. Lew mentioned as well, and that is the whole question of using Social Security Trust Fund money for other purposes. As you know, that has become an area of debate now. Does it matter? Some assert that it really doesn't matter because the way the system works, the funds that come in from the payroll taxes for Social Security get credited to the trust fund, and then how the money is used, some say, really doesn't matter. The money is owed to the trust fund. It will have to be paid at a future point. And so how the money is used in the interim is not a relevant question to the long-term viability of Social Security.

What would your answer be to that, Mr. Bixby? You are focused here on maintaining the integrity of the trust funds or returning to a time of respecting the integrity of the trust funds. Why is that important?

Mr. BIXBY. I think it is very important. We are running a deliberate surplus in the Social Security system right now. It is not an accident. The payroll tax is set at a higher rate than is needed to pay current benefits. That is done to attempt in some way to prefund future obligations, and the only way you can really do that is to use that money to increase savings. Paying down debt, for example, is a way to increase savings, increasing the resources the Government will be able to help—increasing the resources the Government will be able to use in the future to pay these benefits.

You know, many have suggested personal retirement accounts. Many have suggested using the money to invest in some way collectively on behalf of the trust fund.

Whatever method you use with that Social Security money, it ought to be going to prefunding current benefits. Now, if you are just using it to fund other operations of Government or to offset tax cuts for the income tax, then it is a misuse of the payroll tax because you are using a regressive system of taxation that applies on the first dollar to everybody, basically not for the purpose—you are breaking faith with the people you are taxing. In other words, you are taxing them at a higher rate than you need, and you are saying we are going to use this to help fund your benefits in the future, but we are really not. We are using it—we are spending the money now. We are crediting it to a trust fund, which is something of a hoax if you are not really doing something to set the money aside. If you are going to take in the money, spend it, and then credit a bond to the trust fund, you are not doing anything to help the Government pay off that bond in the future. So I think it really does matter.

Now, I look at it as a national savings account, and if you are dipping into it—you might have to do it in an emergency, like we have now. I think that is understandable. But you shouldn't continually get into the habit of using your savings account to buy your groceries, and that is the sort of problem that we face.

Chairman CONRAD. Mr. Lew, what would your answer be to the question of why does it matter whether you use the Social Security Trust Fund money to pay for tax cuts or other Government programs? After all, you have got more money coming in than going out—not this year and not next year, but over time. So since you are crediting the money to the trust fund, what difference does it make?

Mr. LEW. Mr. Chairman, I think the real issue has to do with savings, as Mr. Bixby said, and paying down the debt enabled us to see a trend that was really going to make a difference in terms of our cash position at the point when the baby boom retires.

If you think about the $3 trillion of national debt, if you are left with $3 trillion of debt instead of zero, at a 5 percent interest rate you are going to be paying $150 billion a year in interest. By saving, paying down the debt, you avoid the need to have that annual expenditure, and at the point in time when you need that $150 billion to pay Social Security benefits, it is really there if you have paid down the debt, and it is not really there if you haven't.

I agree that it is dangerous to get too mechanistic about the year-to-year issue. We are in a recession—we are coming out of a recession, I hope. We have seen an attack on the country that required emergency expenditures. But that is very different from charting a whole new course that says it doesn't matter if we pay off the debt. It is going to be exceedingly difficult to pay the benefits that are due under Social Security out of current cash-flow.

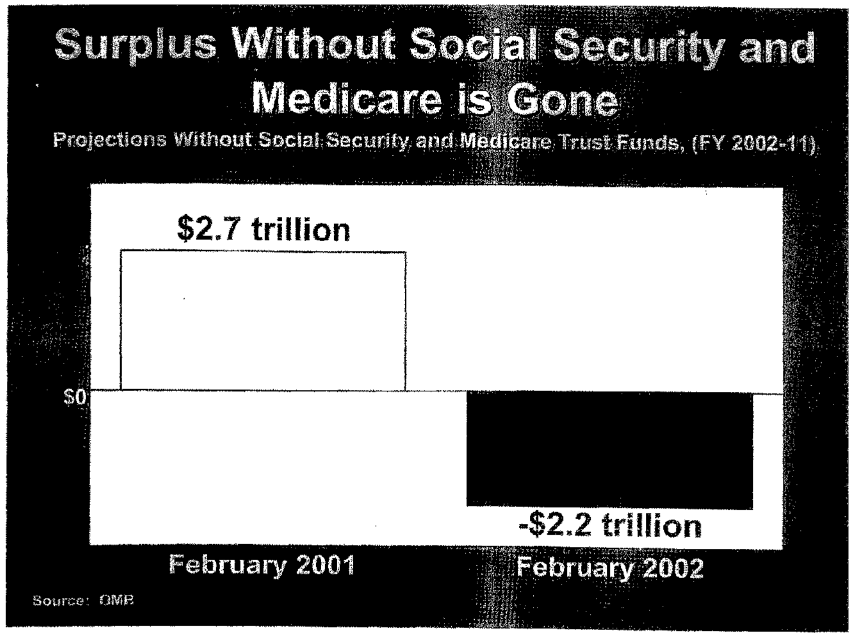
Now, what does that mean? It means that when you get to the retirement of the baby boom, there will be legal obligations owed to the Social Security Trust Fund. But if you are not running a surplus, in order to pay them you will either have to raise taxes or cut spending. That is a very, very different situation from having a forecast where you are running a surplus and you can pay the Social Security benefits out of your running rate.

I would hope that we get back on the path. I am not as optimistic as Bob that a 5-year plan will do it. I think that it will be very difficult to get back on the path.

One thing we learned over the period of time when we were paying down the debt was that saving the Social Security surplus was the only hard line people could understand. If it were possible to have another—a path that got us back toward there, economically it would serve a lot of the same purpose. The problem is that if you don't save it all, it looks like we can't save any of it. That is what this budget shows. We have to get ourselves away from spending all of it and be on a path toward saving, if not all, most of it.

Chairman CONRAD. Let me ask you this. Another question that has come up is: Is there a Medicare Trust Fund? Put up the last chart there.

If you look at the President's budget, it shows over the next decade that nearly $2.2 trillion of trust fund moneys are going to be used for other purposes: nearly $1.7 trillion of Social Security Trust Fund money, about $500 billion of Medicare Trust Fund money.



So now a novel argument has been devised in which people say, well, there is really not a Medicare Trust Fund; there is no Medicare Trust Fund because there is Part A and Part B, and one part is in surplus, and that is the trust fund; the other one is spending general fund money. Therefore, there is really no trust fund.

What say you on that question, Mr. Lew?

Mr. LEW. Well, Mr. Chairman, I would respond, this was something that last year's budget asserted as a principle, and I know I personally was one who took issue with it, because it is contrary to current law. Current law divides Medicare into two parts. There is a hospital part and a doctors' part. The hospital part has a trust fund, and that trust fund runs a surplus. The doctors' bills have always been paid and by law will continue to be paid largely out of general revenue. To assert that that general revenue expense draws down the trust fund is contrary to the way the program is set up. One could change the program. One could say we want to take the Medicare Trust fund for hospitals and spend it on the doctor bills. But that is a change in law. It is not just something one can assume through projections.

I think that given the fact that in 1997 you and I and many others worked together to put Medicare, the Medicare Trust Fund, on a path toward long-term fiscal solvency, it is actually a fairly dangerous idea to just wave a wand and make that go away.

If you go to any hospital in this country, there is serious change, and pain in many cases, because of the law that was enacted in 1997. To now say that the surplus is not really there is not a responsible way to run the program. You can't ask for partnership from the providers to take cuts in order to provide solvency for the trust fund, and then say now we are going to use it for something else.

If anything, the criticism was we went too far in 1997 to get savings. I know you were concerned about the rural providers. Many on this committee were concerned about the impact on urban teaching hospitals. To say that the difficult changes were for nothing strikes me as being a bad public policy argument, and I don't think it reflects current law.

Chairman CONRAD. What would you say, Mr. Bixby, on this question of is there a Medicare Trust Fund and does it matter?

Mr. BIXBY. Well, there is a trust fund, and, yes, I think it does matter. You know, many of the same issues apply. If we are taking in more money on the Part A part of Medicare than we need, then the only way you can dedicate that to the future of the program really is to dedicate it to savings somehow. And so I think that it—you know, we advocated last year that, you know, it would be an appropriate goal to use both the Medicare Part A surplus and the Social Security surplus as a standard and to not dip into those over—not dip into that over the next 10-year period. Of course, things didn't work out that way.

I think on drawing a line, it is much clearer to do with Social Security. I mean, I just think that that is much more ingrained in people's minds. So in terms of—you know, first we have to get back to a unified surplus and then I think start talking about when we can get back to an on-budget surplus. Throwing in Medicare makes it more difficult, and if we try to achieve that standard—I mean, we probably should try to work toward that, but I would be reluctant to throw it into the mix right now because it might make—the goal seems so far off and so distant it couldn't be done.

Medicare does work a little bit differently than Social Security. One of The Concord Coalition's concerns about talking about a Medicare surplus is that it may give people the impression that Medicare doesn't have fiscal problems because Part B is funded out of general revenues. It works different than Part A. But it does require—it has very substantial problems, Medicare does, facing us in the future. And so it has always struck us that maybe it would give the wrong impression to be talking about a Medicare surplus.

But when you talk about it in the context of the budget, then I would agree with you it ought to be devoted to savings.

Chairman Conrad.

Let me ask you this. This Budget Committee has got to try to write a budget resolution.

The President has sent his budget. The President's budget says increase spending dramatically, primarily for defending the Nation, improving homeland security. We all agree that those are the top priorities.

The President's budget says we should also have a significant stimulus package for the economy because of the economic slowdown.

The President says that because of those demands, it is OK to use Social Security and Medicare Trust Fund dollars, but he does not just do it for this year or even for next year. Instead, he does it for the next 10 years. The result is you take more than $2 trillion of trust fund dollars and use them for other purposes. You have just said, both of you, that that is not wise; instead, that money should be used to pay down debt, which expands the pool of societal savings, which means we should have more money available for investment, which means we should have more economic growth, which means we should be better able to meet those obligations in the future as I hear you discuss it.

But that is not what the President's budget does. It takes virtually all—it takes all of the Medicare Trust Fund surplus and takes virtually all of the Social Security Trust Fund surplus.

So the question is what should we do. The President says hold firm to the tax cuts that were passed last year even though the assumptions that undergirded that proposal have evaporated. He was talking about using one in every four surplus dollars, and he was counting Social Security and Medicare money in those surpluses. He said take one in every four and return it to the American people; that is not too much.

With the new calculation, if we applied his formula, one in every four dollars, to $600 billion, which is what is left under his formulation, we would have a $150 billion tax cut, not a $1.6 trillion tax cut that he advocated.

If we used his own formula, you would not have the tax cut that he proposed and pushed through Congress; you would not have a fraction of it. But that is where we are. He says that to do anything else would be to raise taxes.

What would you propose? What would you say to this committee? What should be the fundamental principles that we apply in writing this budget?

Mr. Lew, what would you do—not to put you on the spot.

Mr. LEW. Well, I think it is a very difficult situation, and to some extent it is easy to put me on the spot because I am speaking for myself. Politically, the choices are very hard; analytically, I think they are less hard.

First, I think you have to not make the mistake that was made last year. Last year, a tax cut was moved through before there was a full and open debate about all of the competing demands. The defense review that was announced in last year's budget did not come back until after the tax cut was enacted, and a lot of the spending increases that are proposed now in the name of responding to September 11 actually flowed out of that defense review. If one had waited and done the tax cut and the defense review at the same time, I rather suspect that last year's total fiscal package would have looked different than it does today because of the sequence being done tax cut first.

What does that mean going forward? I think there are two areas where it is almost incumbent on the committee to think very seriously about changing how you think about the tax cuts.

First, the next tax cuts have to be treated as new tax cuts. They cannot just be treated as an extension of current policy. The truth is that they are very expensive, and they should be competing with other things like a defense increase and prescription drug coverage and paying down the debt.

I think harder than that is going back and looking at last year's tax cut. I think you can divide the question and say what has taken effect and what has not taken effect. There are a number of provisions of last year's tax cut that have not yet taken effect. On the rate side, it is the reductions in the highest income tax rates for the highest income brackets, and it is the estate tax provisions.

I have not been able to see estimates that give a pinpoint estimate on what the savings would be from that—you may well have them already—but it is hundreds of billions of dollars.

I am not saying that one should repeal last year's tax cut. I think the question that one has to ask is can we afford it on the schedule that was agreed to last year. Do some of the provisions need to be rescheduled so they can be held off until we know we can afford it.

One thing I know for sure—once they take effect, it becomes far more difficult to reverse them, and if there is ever going to be a debate about the competing demands for scarce public resources, it is going to have to take place before all those provisions take effect.

Now, I realize that politically, we are in an administration that says it would veto any change in last year's tax bill. That is a very difficult proposition, which is why I say that analytically it is a lot easier than it is politically.

Chairman CONRAD. Mr. Bixby, what would be your formulation? What would be your recommendation to this committee on what we should do in terms of fundamental principles to apply?

Mr. BIXBY. Well, I would get back to the idea of establishing that fiscal policy goal of balancing the budget without using the Social Security surplus. You might look at what it would take to do that over a reasonable period of years. It might take more than 5 years, but at least trying to make that the goal.

Once that is established—because that goal has great bipartisan support; it always has—well, for the last 3 or 4 years, anyway, it has—but I really think that that is the starting point, because if you do not have that goal, you sort of have "anything goes" budgeting, and it is really going to be very difficult to constrain spending or to constrain tax cuts, because then it is in the name of what—I mean, what are we trying to achieve here? So it is sort of everyone for himself.

That is a goal that people can rally around and the public can support. Once you do that, I think that everything needs to be on the table, and some of the ideas that Jack talked about come into play at that point.

I realize what the President has said, and that makes it difficult, but as his budget demonstrates, we cannot do everything he has recommended that we do and still wall off the Social Security surplus. So if the goal is to balance the budget without using the Social Security surplus, then, by definition you have to look elsewhere. And one of the things that is out there is the tax provisions that have not yet taken effect.

Chairman CONRAD. Let me ask you this. Is freezing taxes a tax increase, in your judgment? In other words, if you were to defer future scheduled tax cuts, is that a tax increase in your judgment?

Mr. BIXBY. Well, I think that is going to be a highly political and semantic judgment. I could take the Republican side of it and say that if what we did last year was cut taxes, then reversing that would be a tax increase.

But obviously, it does not increase people's taxes from where they are now. I mean, the Concord Coalition's problem with last year's tax cut was not the short-term effect of it, not what has already taken effect—that seems to have been for the good—it is this idea of locking in large, escalating tax cuts over a 10-year period that is fiscally irresponsible. Now we know we are going to have to spend a lot more over that same period. So the playing field has changed dramatically.

So I do not think it is really fair to talk about it as a tax increase, to talk about something that is putting things back on the table for 2004–2006. It seems to me more a matter of just being fiscally responsible than anything else.

But I think those two things put everything on the table. I think you might look at some enforcement mechanisms like pay-go. Caps are going to be difficult since we have an uncertain period on discretionary spending. But certainly that pay-as-you-go discipline really ought to be applied now, because we are back to where we were before we had unified surpluses, so I think it is perfectly legitimate to do that.

Chairman CONRAD. Let me ask you this question. The committee is going to have to decide in the budget resolution do we make the tax cuts that were ut in place last year permanent. What would be your recommendation on that question?

Mr. BIXBY. As I said in the prepared testimony, Concord Coalition does not think that would be a good idea right now. At some point, we are going to have to revisit the tax cut, because the sunset is not going to take effect in 2010. We know that, so at some point, we are going to have to renegotiate this. Now is not the time to do it. In fact, let me just—I thought this was kind of amusing from the budget. They said that Washington's 6-year experiment with 10-year forecasting is proving to be a failure—"2001 showed how unreliable and ultimately futile such estimates are." So they are not going to make 10-year forecasts anymore.

Well, it seems to me it is locking the barn door after the horse has escaped. So we have to look out those 10 years is what I am saying, and making those tax cuts permanent I think would compound the mistake from last year.

Chairman CONRAD. Mr. Lew?

Mr. LEW. I think that at the core of my answer to that is that last year's tax bill was fundamentally a big gamble through triggers that had provisions take effect in the future and sunsets that many of us believed would never be allowed to occur. It shrunk the size into a box that fit the full estimate that was available, and everyone knew it was going to cost more than that and that if the surplus for any reason did not materialize, the triggers would still be very to likely go into effect.

What did it do? It created a dynamic where the question that you are asking is the right question to ask—is it a tax increase to change those effective dates?

The truth is it should not have been enacted in the first case with triggers. One ought to look at policies saying what do we know we can afford now, let us enact what we know we can afford now, and that is not the end of time. You come back the next year, and you ask what can we afford now, and you enact a new policy.

Setting in place a series of things that are scheduled to go in I believe was done precisely to create this confusion as to what is a tax increase and what is not.

For anyone who experienced the tax cut last year—and that is most taxpayers—their taxes will not go up if you delay some of the effective dates for processors that have not yet taken effect. For most people, they will not even see a change in their tax due, because it really affects people at the highest income brackets, which is not most taxpayers.

I think that what it comes down to is that if you gave most Americans a choice and said on the one hand, here is something that is in current law that would cut people's taxes, and here is a way to defend the country, they would say we need to defend the country. If you gave people a choice saying here is a way to cut the taxes in the highest brackets, or here is a way to fund prescription drug benefits, I think most people would say you should fund prescription drug benefits.

I actually believe that if you gave most people a choice that said should we pay down the debt or let the tax cut take effect as scheduled, most people have the common sense to say pay down the debt.

It was a really remarkable——

Chairman CONRAD. Can I just interrupt you on that point? There was a very interesting front page story in the Los Angeles Times yesterday of a poll that was taken that showed that 84 percent of the American people would rather defer the future tax cuts to avoid using Social Security funds to pay for it.

Mr. LEW. I did not see the article, but that certainly supports the view that I am speculating.

I think that it is very important to get away from using triggers and sunsets the way they were used last year, because I think it is like time bomb that goes off, and you may or may not be able to handle the consequences.

I personally believe that rescheduling things so that you can afford what the policy is and so that it puts us back on a path toward fiscal discipline would be much stronger, better policy, and most Americans would be better off if we did that.

Chairman CONRAD. Let me ask you this question. I have not heard anybody propose a tax increase. To me, a tax increase is when you increase the taxes that people are paying now. I have not heard anybody propose that.

I have made very clear that I would not propose that in a budget resolution. I do not think it would be wise to raise taxes in the midst of an economic downturn.

That does take us to the question of economic downturn and whether or not we should provide in the budget resolution resources for a stimulus package. I would be interested in your reflections on that.

Chairman Greenspan, when he was here testifying before the committee, indicated that he is conflicted about that question now. He said that he strongly supported it last year, but in his judgment, the economy will recover whether we have one or not, and if we have one, it will have the negative consequence of adding to deficit and debt, which he does not want to see. On the other hand, he is not confident how strong this recovery will be, so perhaps having some stimulus package would be useful. But he said that he found himself very conflicted on the issue.

Could you each tell us what you think should be done in the budget resolution with respect to making provisions for a stimulus package?

Mr. LEW. Mr. Chairman, I think that by the time the budget resolution actually works its way through the Congress, we may well find ourselves at the beginning of a recovery. I certainly hope that is the case; there are some positive signs; there are mixed signs in the economy.

But I think that that highlights the difficulty of timing a stimulus package to hit at exactly the right moment. I personally, for over 20 years, have watched every time there has been an economic downturn and have never seen it hit right. In 1983, we did not hit it right. I think that last year, it came closer to hitting right than usual. I think that probably would cease to be the case this year. So the likelihood of a package actually hitting the economy at the right moment has diminished greatly because we are farther forward in time.

I think that as important as timing is the composition. Personally, if you look at what lags in a recession, there are problems for people who are unemployed, they are exhausting unemployment benefits. Would it be a good thing to extend unemployment benefits and provide access to assistance for health insurance premiums? That probably would be helpful if it could be done quickly, but if it comes after someone has gone back to work, it misses the mark.

On the tax side, I think that investment incentives that go into the next year and the year after that will not have anything to do with the immediate recovery, and I think that ultimately, the tradeoff of making it a somewhat stronger recovery versus the effect on the deficit is a very tough call.

My own sense, since I am not confident that the mix would end up being one that I thought was very effective, is that nothing is better than a badly targeted stimulus package. If you could do something small, quickly, particularly to help on the human side, it would probably be worthwhile, but if that is not possible, I would keep my eye on the fiscal impact.

Chairman CONRAD. Mr. Bixby, what would be your recommendation?

Mr. BIXBY. I think the case for an economic stimulus, particularly one the size that has been proposed, is getting weaker as time goes by, and I think that doing something to round off the rough edges, smooth off the rough edges of the recession, such as extending unemployment benefits, still makes some sense. But a large-scale stimulus package probably would be ill-timed. If it looked like the economy was getting worse, then the judgment might be different, but in the last couple of months, signs have been good—the slow, steady progress—it is not like there is going to be a big boom right around the corner, but I do think that in looking at the mix between the cost to the budget and the likely benefit to the economy, the factors are not weighted in favor of not having a stimulus bill.

Chairman CONRAD. All right. Let me make one mention—Mr. Bixby, you indicated that Republicans ought to take credit for the tax cuts that were put in place last year, at least the near-term part of it, because of the lift they gave the economy, the stimulus effect.

Just for the record and to remind people of what occurred, there was actually bipartisan support for tax cuts in the first year, and actually for the 10 years. In fact, Democrats proposed much greater tax cuts for last year to provide stimulus to the economy than did the President's budget.

You will recall that the President's tax cuts were very back-end-loaded; there was almost nothing for last year. In the budget that I proposed on behalf of Democrats in the Senate, we had $60 billion of tax cuts for last year to give lift to the economy.

It was over the 10 years that we had much smaller tax cuts, because we thought that the President's proposal would threaten Social Security and Medicare, which has proven to be all too much the case.

But the reality is that Democrats proposed and voted for a more aggressive package of tax cuts to give lift to the economy last year than the President proposed. It is true that we had a substantially smaller package over the 10 years because of the threat that we saw to Social Security and Medicare. Our package on a fair comparison basis to the President's $1.6 trillion was $750 billion of tax cuts over the 10 years. With debt service included, our package was $900 billion, and his was approaching $2 trillion.

Let me ask you this on caps and pay-go, an issue before the committee. Do we reestablish caps and pay-go? What would Concord Coalition say to us on that issue, Mr. Bixby?

Mr. BIXBY. Well, I think you should. I think there have been effective enforcement devices, particularly when deficits were forecast, so the fact that they are expiring this year is somewhat troubling when we are looking at deficits again.

The goal of the Balanced Budget Act in 2000 and 1997 was to achieve a balanced budget by 2002, and the irony is that we have had surpluses every year since then, and here we are in 2002, and we are back into deficit.

So I think that that is a good reason to renew caps and pay-go.

Now, let me say on your earlier point, Mr. Chairman, that you are absolutely right, and your point is well-taken. I was giving gratuitous political advice and saying that perhaps they should leave well enough alone with the tax cuts and declare victory and get out. Your point is well-taken.

One of our problems with the original tax cut as proposed by the President was that it had so little stimulus—almost nothing in the first year—and it was being billed as a stimulus. So that perhaps was not a serious comment on my part, but your point is well-taken, and I stand corrected.

Chairman CONRAD. Let me just ask you this. We have talked about the revenue side of the equation, but obviously, when we look at deficits and debt, there are two sides to that equation—the revenue side of the equation and the spending side of the equation—and both of them have to be dealt with if we are going to be successful. One of the interesting facts that emerges—we have just done an analysis of spending over a length period of time, Federal spending, total Federal spending, and what we see is that, of course, in dollar terms, it has gone up; but as a percentage of the gross domestic product, which economists say is the best way to analyze a budget over time to take out the effects of inflation, what you see is quite a different picture. You see that Federal spending as a share of our national income has been in quite sharp decline. In fact, in the early nineties, we were at over 22 percent of gross domestic product for total Federal spending. That is down now to about 19 percent, a rather significant decline—a decline of almost 15 percent in real terms.

Now, of course, we have seen a bump up with the requirements of defense and homeland security, but even with that, if you look at the President's budget, we will continue to see Federal spending as a share of gross domestic product continue to decline to the lowest level since sometime in the mid-sixties.

Let me just ask for your analysis of what has happened to Federal spending in terms of that kind of analysis.

Mr. LEW. Mr. Chairman, I think you are correct that spending has declined as a percentage of the economy. In terms of how one sets limits for discretionary spending, there is a real tension. If one tries to set a limit to hit an overall fiscal target, there is a temptation to treat the outyear numbers, anything other than the year we are in, as if savings are achievable when they may not be achievable. I think we have seen that in every budget agreement that I have ever witnessed. There is a tendency to say after 2 or 3 years that you can start holding it down more than it turns out you really can. And there is a reason for that. To keep discretionary spending growing below inflation means reducing it in real terms. If you are talking about a program that buys milk, like the WIC program, it means buying less milk. If you are talking about a program that buys any goods and services, you are going to get less if you do not allow for inflation.

I think that that is what makes the assumptions in the budget so difficult, because it may not sound like that much to be cutting $200 billion over 10 years on something as large as the Federal Government, but what it means is holding to a rate at least one and maybe more than 1 percent below inflation on everything other than defense and homeland security. We have not seen that that is possible.

Now, if it is not really achievable, to assume it gives you a false basis for making policy judgments. If you go back to caps, I would strongly recommend that you use caps that are as accurate as possible in terms of the likely required level. No one likes to be for undifferentiated pots that we can call "domestic spending." It is easy to stand up and say an increase in education or an increase in biomedical research. When it is just a big number that says "domestic spending growing," it has a different character; but when you translate it, if the number is not big enough, then you cannot fund education, you cannot fund biomedical research or environmental protection.

One thing that is interesting in terms of the response after September 11 is that there are a lot of functions that we used to consider core Government functions that people always said could be cut. Well, it turns out they cannot be cut, because those are being increased—whether it is Customs or airport programs—things that are not terribly glamorous until you have a crisis but that are the nuts and bolts that serve the American people for the most part quite well.

If the pressure is to assume that it can all be constrained below inflation, I do not think that that goal will be realized, and I do not think that is a partisan issue. I think it is going to be just a reflection of reality. In order to start with an honest, accurate baseline, one has to confront that difficult issue.

Chairman CONRAD. You know, this is going to be an especially challenging time to write a budget, for the reasons that I have set out. Clearly, we have got to increase spending on national defense and homeland security. We are very much united on that question.

I do not think it would be wise to increase taxes at a time of economic downturn, and I will not propose such a thing. But for the longer term, I must say I am very worried about the direction of taking $2 trillion out of the trust funds of Social Security and Medicare to pay for tax cuts and to pay for other Government spending. I think that is a profound mistake. I said that to Mr. Daniels yesterday, and I believe it.

And what kind of choices does that leave us with? They are all difficult ones; they are all very difficult ones. And at this point, there is not much of a consensus on any of the questions before us that I have raised here today. There are differences with respect to a stimulus package. The President still believes that it is critically important to put one in place. Chairman Green said he is conflicted on the question. I have had a number of colleagues come to me in the last several days and say they now think a stimulus package would be counterproductive, that it would dig the hole deeper in terms of deficit and debt and would probably be too late to give lift to the economy.

One of the things that we did as budgeteers was an analysis of past attempts by Congress to stimulate the economy at a time of economic slowdown. Do you know what we found? Every, single time, we have been too late. Every, single time, we have acted too late. It turns out that because on a bipartisan basis, we did push for tax cuts last year because we thought it was important to give lift to the economy, and because of the increased spending resulting from the attack on the country, those things did provide stimulus, in fact, very substantial stimulus last year—more than $100 billion of stimulus in this period.

So the question is do we do more, and if so, what does it include.

Let me just say that I very much appreciate the two of you being here to share your views with us. I wish more of our members had been here to have a chance to hear from you, but this is all part of the record, and their staffs are here and have been listening attentively, and I can tell you that your recommendations will be important to us.

Before I end the hearing, let me ask you about the question of debt limit. Last year, we were told that we would not face an increase in the debt limit until 2008 or perhaps 2009. Now the Treasury is calling over here, saying you have got to increase the debt limit of the country as quickly as possible, and increase the debt limit by $700 or $800 billion.

It is a stunning turnaround. Those who said last year that you could have it all, that you could have massive tax cuts, that you could have aggressive paydown—in fact, you could pay off as much of the debt as was possible to pay off—that you could have a major military buildup, that you could have protection for Social Security and Medicare were just wrong. They were just wrong. They have been proven wrong on every, single count. They are not protecting Social Security and Medicare. They are raiding Social Security and Medicare. They said you could have all of these additional spending items and tax cuts and still have maximum paydown of debt. That is all gone. Instead of paying down $2 trillion of debt, they are now saying that at most, they are going to pay down $500 billion, and the assumptions behind that are very murky and very doubtful.

So the hard reality is that all of these things that we were told last year proved to be wrong. They said that we would not have to increase the debt limit of the country until way off in the future; now they are asking for an immediate and big increase in the debt limit.

What would be your advice? Clearly, the Government of the United States has to meet its obligations. It would be a disaster for the Government to default. But should we have a big increase all in one fell swoop, or should we take repeated reviews of our debt situation?

What would be your advice?

Mr. LEW. The debt limit is one of the more vexing problems, because by the time you get to the debt limit, it is too late to really affect the policy that caused the need for the debt limit to occur. It is kind of a lagging indicator.

I think that in the short term, there is really very little alternative but to, as you say, do what it takes for the Government to pay its bills. Default is not an option.

I think that it is a point of leverage that has been used from time to time. My own personal is that it has been overused; it has made the orderly management of Government more difficult for both Republican and Democrat administrations. Years ago, when I worked in the House when the Democrats controlled the House and the Republicans were in the White House, we came up with an automatic mechanism for a debt bill to pass because we could never get anyone to vote for it, and we had this kind of crisis mentality around the debt limit.

On the other hand, I personally would not have a huge increase, because you need to keep pressure on the system so that future policies can be made with an eye toward what the impact on the debt is. And at the point where you debate the budget resolution, I think it should be very much in front of this committee and the full Senate what the impact will be on the debt, and the decision on the policy ought to be made with an eye toward what it is going to require in terms of the debt limit when it comes up the next time.

Chairman CONRAD. Mr. Bixby, what would you say on the debt limit?

Mr. BIXBY. I think that having a huge increase in the debt limit at this time would be a mistake, because the fiscal outlook right now is very uncertain, or does not appear good. I would agree that once you get to the point where you are bumping up against the debt limit, it needs to be raised, but I would keep the increase to a fairly small level at this point so it would help keep control over fiscal policy a little bit better and act as a check, so we have to come back and look at it again.

It is one of the ultimate ironies of this year that one of the justifications for the tax cut last year was that we were going to pay off the national debt too fast; and now, we begin this year by debating how soon we have to raise the debt limit. So things change very quickly, and I would keep the increase to a fairly small one.

Chairman CONRAD. All right. I think that is very good advice.

Do you have any other last comments or last suggestions to us, things that we should keep in mind as we try to deal with this series of challenges?

Mr. LEW. The one thing I guess I would say as a closing comment is that this is not the first time that a year after a large tax cut, it turned out not to work. In 1981, exactly the same thing happened, and to the credit of President Reagan and his administration, they worked with the Congress in 1983 and in subsequent years to be responsible about what the impact was. It obviously was not enough, and it took the better part of 20 years to really turn things around, but it would have been a lot worse if we had waited 10 years to get started.

I would just hope that the model that is looked to in terms of how to deal with the consequences of policy decisions made is more like that than some other examples that are being used which would suggest that we just barrel ahead regardless of the consequences.

Chairman CONRAD. Dig the hole deeper. I think the most disturbing thing about the budget that I see coming from the President is that it just digs the hole deeper and deeper and deeper. There does not seem to be any plan at all to return to fiscal balance.

Mr. Bixby?

Mr. BIXBY. The problem with getting back into deficits for a legitimate reason, whether it is war, recession, or a combination of both, is that once back into them, people get comfortable with the idea. It is like who cares about all that fiscal discipline stuff—yahoo, we are out of the lockbox.

Getting back into that lockbox is going to be tough, and what The Concord Coalition is concerned about is the return to the old habit of let us cut taxes, increase spending, spend the Social Security surplus, and run up the debt. We just cannot afford to do that with the boomers beginning to collect their benefits by the end of this decade.

So our strong plea is that this is a very crucial point for the fiscal and economic future of the country, and maintaining fiscal discipline is going to require some hard work, but it is work worth doing, because we are really doing it in the name of future generations, and we have always said that patriotism includes generational patriotism. We need to look out for the future of the kids and grandkids that we leave behind, and that now becomes a short-term concern of ours as you prepare your budget for this year.

Chairman CONRAD. Thank you for that.

On that note, we will end the hearing, and I want to thank you both again very much for being advocates for fiscal balance and for paying attention to what really will make a great difference to the long-term fiscal security of the Nation.

Thank you very much.

[Whereupon, at 11:25 a.m., the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSALS

THURSDAY, FEBRUARY 7, 2002

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, Byrd, Nelson, Stabenow, Corzine, Snowe, Smith, and Allard.

Staff present: Mary Ann Naylor, staff director.

For the minority: G. William Hoagland, staff director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Good morning, and welcome.

It is good to have you here, Mr. Secretary. As I was describing to you, the leadership on both sides had indicated there was going to be a vote at roughly 10:05, so some of our members have gone to the floor in anticipation of that.

They have now put that vote off for some indeterminate period, so I think we will press ahead and try to get through statements, and hopefully, we will be able to do that before the vote actually occurs.

I want to acknowledge this morning that Senator Gordon Smith of Oregon will be serving as the ranking member in the absence of Senator Domenici, who remains in the hospital for tests. All of us on this Committee again send our best wishes to him. He is an invaluable member of this Committee and of the Senate, and we miss him, and we are hoping that these tests are completed successfully and that he is back with us very soon.

I want to again welcome you, Mr. Secretary, for a return to the committee. We are delighted that you are here. We have been through a year of remarkable changes. I think we all have to acknowledge that and state it clearly.

Last year, we were told that we were going to be blessed with extraordinary surpluses as far as the eye could see. Obviously, that course was altered in the first instance by recession, and war, which for this year and next played the biggest role in reducing those surpluses.

But over the next 10 years, we see the biggest factor in the reduction of surpluses being the tax cut. CBO told us that about 42 percent of the change is as a result of the tax cut over 10 years; 23 percent, the economic downturn; some 18 percent, spending that came about as a result of the attacks on this country; and 17 percent, technical changes, largely increases in Medicare and Medicaid expenses that were not anticipated.

Last year, you came before the committee, and you were a staunch defender of the tax cut, which is understandable as a representative of the administration. I think that many people might have had a different view if they had known everything that was to come. Certainly if we had applied the President's own formula, which was one in every four surplus dollars for a tax cut, the tax cut would have been dramatically smaller, because we are now down to under, the President's budget, a $600 billion surplus over the 10 years, and one-quarter of $600 billion would be a $150 billion tax cut instead of a $1.6 trillion tax cut.

But people were using what they thought were the best forecasts at the time.

When you appeared before us last March, you used a reference that stuck in my mind ever since, a reference to a well-known fairy tale, and you talked about characterizing the tax cut plan as a "Goldilocks" tax relief plan—not too big, not too small, but just right.

When you explained the math to the committee last year and you outlined it, as in this chart, you indicated that starting with the $5.6 trillion surplus, take away the $2.6 Social Security surpluses and $1.6 trillion for tax relief, and we are left with a $1.4 trillion cushion.

Today, as I have indicated, we face a far different picture, with those surpluses largely disappearing. All of this tells me that a prudent person putting out a budget this year would decide not to dig the hole deeper. In fact, I do not think it would be a bad idea if the administration and Congress kept in mind the observation that you made earlier this week at the Finance Committee. You said that "10-year projections ar a useful discipline, but they are not rock-solid predictions." This is a point that I tried to make last year and certainly alerted people to last year, that any 10-year projection is a crapshoot. I think we do need to remind ourselves of that fact.

But in this context, the President now comes with a budget with another $600 billion of tax cuts, all of which is going to be coming out of Social Security Trust Funds. I personally think that that is a serious mistake in light of the fact that the baby boom generation starts to retire in just 6 years.

In addition, the tax cuts that the President proposes are heavily backloaded. Maybe we could put up that chart. More than 70 percent of the tax cuts being proposed by the administration will take effect in the second 5 years. More than 40 percent of the cuts take place only in 2012, the final year of this budget window. And the cost of these additional tax cuts in the second 10 years is $4 trillion—right at the time when the baby boom generation is retiring and the fiscal condition of the country is dramatically altered by that fact.

Leaving aside the tax policy problems with what the President has proposed, what is especially troubling to me and to many Members of the Senate is the taking of Social Security and Medicare Trust Fund surplus money to use for other purposes.

Remember what you said last year to the Finance Committee on the subject of protecting Social Security—as a member of that committee, I remember it very well. You said: “The Social Security dollars that are going to flow into the government over the next 10 years are safeguarded, lockboxed, fenced off, protected from all evildoers. I do not know if there are more strong ways to say it. Social Security dollars are set aside without any threat of encroachment.”

Now, we look back, and we see that that is just not so. If we look at what we are faced with now, if we go back to the bad, old days, 1996 and 1997, we were taking all the Social Security Trust Fund money and using it for other purposes. We were able to reduce that in 1998. We were able to stop the practice completely in 1999 and 2000, when we took none of the Social Security surpluses for other purposes.

But now we have seen a reversal. In 2001, it started in a relatively modest way, but the next 3 years under the President’s budget, we are taking all of the Social Security surpluses to be used for other purposes. And over the next decade under the President’s plan, $1.7 trillion of Social Security surpluses will be taken to pay for tax cuts and other expenditures of government.

The President’s plan has enormous consequences. Last year, you assured us that we would be able to pay down as much of the publicly held debt as was possible to do—some $2 trillion. And now, we see that instead of being able to pay down $2 trillion of debt, that is dramatically reduced to $521 billion.

The result is that Federal interest costs go up dramatically. Last year, we were told that over the next decade, we would pay some $600 billion in interest costs. That has now been increased to $1.6 trillion. That is $1 trillion that is going out in interest costs that is not available to strengthen our national defense or improve homeland security or meet the other pressing needs of the country—or to pay down debt.

I believe the truth is there are no surpluses left—none. I think their words mislead us, perhaps. I think they certainly mislead the American people. I believe that to the extent surpluses are from trust funds, that those funds are already fully committed and should not be designated as surpluses.

Before Chairman Greenspan’s testimony before this committee, he and I had a very interesting conversation. He said that one of the things that has concerned him is the liabilities that the Federal Government has that are not on the books of the Federal Government, and they are not on the books of the Federal Government because the theory is that the Federal Government could stop the programs of Social Security and Medicare, so those liabilities are considered contingent liabilities.

As Chairman Greenspan said to me, in his judgment, the vast majority of it is not contingent at all. And that is why I liken this to the Enron theory. I am not accusing anybody of corruption here; that is not the point. The point is that as I understand it, the biggest problem with Enron is that they did not face up to their true debt. In effect, they were hiding debt from creditors, from shareholders, and perhaps even from themselves. Perhaps there were executives there who did not fully appreciate the amount of debt that they had. I would not be surprised by that. Frankly, I would not be surprised if there are colleagues who do not fully appreciate the debt that we have.

So the use of language is important, and I have become increasingly concerned that when there is talk in Washington of surpluses, that sends a signal to people across the country that there is money here that is available for spending, that is available for tax cuts—that it is extra; that it is beyond what the need is. I do not think that is the case. I really do not think we have surpluses.

In many ways, what I am talking about is a very conservative view. I can tell you that there are people who do not welcome it on my side of the aisle. But I believe that it is the case.

Where will it lead us? CBO Director Crippen concluded his testimony here by saying "Put more starkly, Mr. Chairman, the extremes of what will be required to address our requirement are these: We will have to increase borrowing by very large, likely unsustainable, amounts, raise taxes to 30 percent of gross domestic product"—we are at 19 percent now; that is not his quote, that is my statement—back to his quote now—"obviously unprecedented in our history"—that is, to go to 30 percent of GDP for taxes—"or eliminate most of the rest of government as we know it. That is the dilemma that faces us in the long run, Mr. Chairman, and these next 10 years will only be the beginning."

This is the reality that is just beyond this 10-year budget horizon, and I think it has got to inform all of our actions—administration proposals, congressional action—and if we believe that that is the case, if we believe that that is where we are headed, that has got to put a brake on what we do on both the spending side and the tax cutting side. That is my own strongly held belief.

I believe that Director Crippen gave us the hard truth, and as I have said before, I believe the President's budget fails to address that long-term fiscal imbalance facing the country. And I believe that his proposal—not so much the short-term; that is not to me the issue. I am much less concerned with this year's budget and even to some extent next year's budget. I am much more concerned about our long-term glide-slope here and where it is taking us.

Mr. Secretary, that is my own view of our condition, and my disagreement with the Administration is a fundamental one. It does not flow from any disrespect or disregard. In fact, as I have expressed before and I have expressed to you, I have the highest regard for the President's management of the war effort and for the conduct of this Administration in facing this incredible challenge to our Nation.0

I must say that there have been many times sitting at home where I have felt real pride in how the President has conducted himself, how you, Mr. Secretary, have conducted yourself, and I acknowledge that fully here.

The disagreement I have is that I think we are on a long-term course that does not add up and puts our long-term financial security in jeopardy.

With that—well, that is more red ink—let me now turn to my colleague, Senator Smith, from Oregon, who is filling in for Senator Domenici. We welcome Senator Smith to this role. He is a very articulate and very knowledgeable member of this committee, and we will have time now for his observations.

OPENING STATEMENT OF SENATOR SMITH

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

I appreciate your leadership on this Committee and your active use of the gavel to educate the American people of the choices that we have.

I also thank you for your comments about Senator Domenici, and I think we all join in a prayer for his well-being and hope for the very best results from the testing he is having today.

I honestly do not know of a better person in the United States Senate than Pete Domenici, and that is as high a praise as I can give, because I know many wonderful people in the United States Senate. So I do not suppose anybody feels more keenly the size of his shoes this morning than I do, because he has asked me to fit in them as best I can this morning.

Mr. Secretary, I thank you for coming this morning. We have received the President's budget, and with some exception, I think it is an excellent budget. It is a war-time budget, and I think it lays out clearly the priorities that our Nation has to win the war, to better secure our homeland, and to restore economic health to our economy.

It is a $2.1 trillion budget. That is a lot of money. And I know that you are having a lot of your statements held up to you this morning. My mother used to say "Make your words soft and gentle, because tomorrow you may have to eat them."

I think the point that I would make to anybody who cares to be fair is that you made those statements before murderers crashed into our buildings and took us to war. That is an extraordinary circumstance that no one could have foreseen fully, and we are in an emergency, and the budget that you have submitted reflects that.

I want to express publicly my disappointment that the Senate has failed to move a stimulus package to conference. I will admit to you, Mr. Secretary, that I voted for Senator Daschle's bill yesterday; I voted for the centrist bill yesterday; I voted for any bill that could get to conference where we could produce a product that the President could sign, because it does seem to me that your budget assumes that we are going to have from a stimulus package an additional 5 percent growth and an additional 300,000 jobs as a result of that stimulus.

We are not going to have that now, and I am very disappointed in that, because I have never felt that either side here had a monopoly on the truth. It does seem to me that the Democrats have focused on the demand side in terms of unemployment and health care, and I support that. I have said it time and again on television and today. I support that, and that is why I voted for Senator Daschle's bill.

But I think the Republicans had many good ideas with respect to the supply side, the tax side of the equation, that actually does stimulate the economy, and I felt that in fairness to both sides, we should pursue the best ideas on both sides.

But I think it is fair to say that there is an honest disagreement between the parties when it comes to the budget and the role of

Government. I listened to our Chairman, and with great respect, I simply feel that in an emergency like this, the green-eyeshade view of the budget, as though these numbers are static, frankly does not add up for me. It does not respond to the times that we are in.

I do not believe that we can tax our way to prosperity. I believe we should grow our way back to prosperity and surplus, and I think that that is what the President is trying to do.

I have a difference of opinion also on the tax cut that we passed. I truly believe that it is just right and just in time and that it can be helpful to making sure this recession is not too long and not too deep. So I am proud to have supported it.

My view of Government, and frankly, the reason why I am a Republican, is the belief that if we leave more economic choices to the American people, we are going to have a freer society and a more prosperous economy because we will lift more people from the ranks of poverty because we provide them opportunity and freedom of choice.

It does seem to me that when we have paraded through our office every manner of worthy cause that can be solved if only we can open the public purse just a little more, at the end of the day, it is hard to say now. I plead guilty to that. I do not like to say no. I would prefer to be Santa than Scrooge. That is a problem we have around here, and to that end, I really appreciate our Chairman because he is always reminding us of the black and white numbers. But I would just simply say for the record that the money that we have here, this $2.1 trillion that we take and spend of the American people's, 20 percent of our economy every year, that money is all fungible whether you have it on budget or off budget. Senator Conrad and I are both going to vote for the farm bill. We have similar feelings on farm policy. We are both going to vote for his transportation bill. We are every going to vote for his disaster relief for flooding bill. I am likely to vote for many of the things that he will vote for. But all of that, by the formula that he has laid out, takes away from the Social Security and Medicare Trust Funds just as the tax cut does under the criteria that he has laid out.

So it just seems to me that our better macro policy is reflected in the President's budget, that we should grow our way to prosperity and not tax our way to prosperity—we cannot do it. We cannot centrally plan this Government and be serious about the freedom of the American people.

Having said that, Mr. Secretary, there is one area that is a pet peeve of mine. It is about what I see as a moral omission in our country. And given how much we already spend for medicine in this country, it is an ongoing disappointment of mine that we continue to have 40 million of our citizens without health care, and that number is growing.

It does seem to me that there ought to be ways—and I know the President has made a good start in his budget with some tax ideas on credits to help the uninsured to access health care—but perhaps there is something more that we can do in terms of community health centers; maybe there is more that we can do in terms of incentivizing small businesses to be able to provide health care. It is a number that, again, I think is a moral omission in our country, an d we ought to address it more earnestly. And I think that for a Republican President, it would be like Nixon going to China, if you will, to take leadership on that issue.

So I encourage that. I think we are spending a lot on medicine, and we are not getting the best bang for the medical buck, and we ought to figure out how to do that.

I note that you and I were both at the Davos Forum in New York last week, and you had a certain Irish rock star who came out of the closet and announced that he was a Republican activist—I was surprised by that—by the name of "Bono." You made a good friend there, and I understand that you will be going with him to Africa to work on the AIDS issue. I congratulate you for that, I encourage you for that, and I know that what we do to help on AIDS does also affect our trust funds; but we are in a real dilemma in terms of wrestling with this plague of our time to find a cure, and we need to do our part as a country.

So Mr. Secretary, I admire you, I thank you for your service. You do not need this job, but you are doing a very fine job, and I am honored to have you here.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Smith.

I just want to make clear that my concern about taking money from the trust funds to pay for other things is when I see the administration proposing to do it not at the time of recession—that I could live with, that I could accept—it is when they are forecasting strong economic growth. And it is not just temporary. It is not just now, in the middle of this conflict—and frankly, this conflict is not all that expensive; the recession has been more of a drain—but they are talking about taking $2 trillion out of the trust funds over the whole next decade, and they are forecasting strong economic growth during that period.

I would just say to you that my own belief is that we have got to be willing to pay for what we want to spend, and that is especially critical when we have this baby boom generation poised to retire. That is going to change the fiscal outlook for the country. So I just think it is unwise to be taking money out of the trust funds for this entire decade, when it is the decade that the baby boomers start to retire.

We are very close to a vote, and Senator Stabenow is going to have to preside, so I want to give her a chance to make a statement now.

OPENING STATEMENT OF SENATOR STABENOW

Senator STABENOW. Thank you very much, Mr. Chairman. I appreciate that.

Mr. Secretary, welcome back to the Senate Budget Committee. Obviously, we are in a very different, dramatically different, fiscal situation than we were when you appeared before us last year, and as the Chairman indicated, we all share grave concern about the future as it relates to our economic situation and our budget situation.

Our $5.6 trillion surplus is almost down to zero, which is astounding when you take into account the President's budget and the tax proposals.

Today you come before us not just as the President's top tax policy advisor, but of course, you are also responsible for managing our national debt and for paying our country's bills, which is an incredible responsibility. In this light, you have a tough job ahead of you, and our country is now at war, and there is unanimous—unanimous—bipartisan support for our military efforts overseas. In addition, we are expanding our defenses here at home by vastly increasing our homeland security, and this is also widely supported on a bipartisan basis. The focus on safety and security, we all understand is critical for us.

These efforts are necessary and of course are our highest priority. However, our war against terrorism requires us to closely examine our budget priorities now and over the next several years, and that is really what this committee is responsible for, as is the entire Congress, and that is what we wrestle with—good ideas, but all of which we cannot do at the same time. Can we fight the war? Can we also provide the large tax cuts passed last year which benefit the top one or 2 percent of the public and at the same time pay down the national debt? Should we allow Social Security and Medicare Trust Funds to be used to pay for those tax cuts when the tax cuts benefit a few and Social Security and Medicare benefit everyone?

That is really the question that I have, and I have to say no, that that is not acceptable as a tradeoff. And while I have said in the past that these are certainly not connected legally, it feels a lot like Enron to me, with the top one or 2 percent taking money out of the company and leaving everybody else to pay for it with their retirement funds.

So we have some tough decisions to make, and certainly there have been good ideas on both sides of the aisle with my colleagues, and I certainly send with my colleagues every best with to Senator Domenici, who is such an extraordinary leader on budget. He has had ideas, for instance, on payroll tax holidays that have had support on both sides of the aisle, and there are a number of ideas that put money in the pocket of business and individuals and do it in a way that are not a long term drain on Social Security and Medicare.

So we have a lot of tough decisions. Our country is going to have to grapple with those. We welcome your leadership, and we have critical decisions to make that we need to make together in the best interests of all Americans.

With that, the committee will take a short recess in order to vote, and then the committee will be back.

Thank you.

[Recess.]

Chairman CONRAD. On behalf of the committee, I want to apologize to the Secretary. You understand that this place is sometimes unpredictable with respect to votes, and that has been the case this morning.

We hope now that we will have clear sailing for an hour or so. As is our standard practice and with the agreement of the ranking member, we will go to the testimony of the Secretary, and then we will have our usual practice of 7-minute rounds for each of the members.

Mr. Secretary, please proceed.

STATEMENT OF HON. PAUL T. O'NEILL, SECRETARY, UNITED STATES DEPARTMENT OF THE TREASURY

Secretary O'NEILL. Thank you very much, Mr. Chairman, Senator Smith.

I want to join in the comments that each of the members have made so far in recognizing Senator Domenici who is not here today. He is a friend of long standing, and I agree with the sentiments expressed. He is a great human being, and I join you in wishing him well and a speedy return to his work here.

If it is OK with the chair, I have a short statement, 7 or 8 minutes' worth, that I would like to read if it is all right with you.

First of all, thank you for inviting me to testify today. We have had a year to work together, and you know that I am an optimist about the United States economy, especially its long-term prospects.

I believe that we have a huge untapped potential that can and will be unleashed to spread higher levels of prosperity throughout our Nation.

Even after a difficult year, my optimism about the fundamentals of the United States economy has not changed at all. I believe that we were on the verge of recovery before the September 11 terrorist attacks and that our resilience and determination have brought us back to the early stages of recovery today.

We see more signs every day indicating that the seeds for a recovery are there and only need nourishing to speed the process of putting Americans back to work. I believe that we will return to prosperous economic growth rates of 3 to 3.5 percent as soon as the fourth quarter of this year. I am disappointed that the Senate was not able to vote out a bill to speed job creation to more quickly return Americans to work in its actions yesterday.

Strengthening our economy is the key goal of the President's budget. A return to our normal growth rates means jobs for the 1.4 million Americans who have lost their jobs during this recession. Just as strengthening our economy means greater prosperity for the Nation's people, it also means greater strength for our Government. It means greater revenues going into the Treasury without raising taxes, giving us the resources to address the Nation's needs and the retirement of even more Federal debt, leading to long-term economic security for our children.

Even with all that must be done to enhance our security, we expect that a return to economic growth will bring us back to Government surplus in the year 2005.

The economy's slowdown began in mid-2000, when GDP and job growth slowed sharply. Business capital spending began to plummet in late 2000 and accelerated its decline in 2001, dragging down the economy. In August, we were beginning to see the evidence of an economic rebound.

I believe that had it not been for the terrorist attacks of September 11, we would have seen an end to the economic downturn and would perhaps have avoided a recession. The September 11 attacks created shock waves that rippled throughout all sectors of the economy. Financial markets were shut down for almost a week. Air transportation came to a standstill, and as a result, GDP fell 1.3 percent at an annual rate in the third quarter.

By late November, the National Bureau of Economic Research declared that the United States was in a recession. They designated the end of the previous expansion to be March 2001, but they observed that the slowdown might not have met their qualitative standards for recession without the sharp declines in activity that followed the terrorist attacks.

In sum, the scorecards for the economy in 2001 reflected a combination of adverse events: The private sector lost more than 1.5 million jobs; the unemployment rate rose 1.8 percent points; industrial production was off nearly percent during the year; and at the end of the year, industry was using something just less than 75 percent of its productive capacity.

As bad as these numbers are, they could have been worse. The well-timed bipartisan tax relief package which you all voted put $36 billion directly into consumers' hands in the late summer and early fall—in fact, beginning on July 23, providing much-needed support as the economy sagged. It was, we believe, the right thing to do at just the right time.

It is not surprising, then, that both the Congressional Budget Office and the Office of Management and Budget project deficits for this year and next as a result of the economic slowdown and the response to the September 11 attacks.

The President has presented a budget to speed our recovery. First, the budget includes tax relief to stimulate job creation. Unfortunately, it now appears that we are not going to see the action the President began recommending on October 5 which would have accelerated depreciation and speeded up the tax rates that had earlier been enacted for subsequent effectiveness, not providing checks in the form that I think was largely agreed on both sides of the aisle for those who were tax filers but did not participate in the tax rebate program of last year. I think it is too bad that we were not able to get those actions taken. But we do welcome the fact that by unanimous consent yesterday, the Senate did agree to go forward with an extension of the unemployment insurance benefits for 13 weeks.

Second, the President's budget proposes strict fiscal discipline, increasing spending for national security and homeland defense, and holding the line on other spending. His management agenda calls for performance measures to be used to determine where budget increases are allocated so that our resources go into the projects and programs that make the biggest difference in people's lives.

As the experience of the 1990's showed, this discipline is crucial to ensuring that we do not return to systemic deficits of the past. But fiscal discipline alone will not guarantee budget surpluses. We must return to 3 and 3.5 percent annual growth to ensure surpluses for years to come.

The focus needs to be on restoring growth. Surpluses will then follow naturally. We believe that raising taxes would stifle the process of getting Americans back to work. We think that tax increases at this point in our recovery is a very bad idea.

According to the 1999 data, the most recent available, 33 million small business owners and entrepreneurs pay taxes under the individual income tax rates. They have made business plans that assume that the tax relief enacted last summer will take place as scheduled. And importantly, 80 percent of the benefit of cutting the top two rates goes to small business owners and entrepreneurs. They are the engines of job creation in our economy.

We believe again that tax relief, if it were accelerated as the President proposed, would boost job creation. Such relief we believe would have no affect on long-term interest rates. In fact the Council of Economic Advisers estimated that a $1 trillion change in the public debt over 10 years would tend to raise the long-term interest rates by 14 basis points. And importantly, since the tax cut last year, the 10-year nominal rate has averaged 4.93 percent—I think this morning, it was trading at 4.90—which is substantially below the 6.16 percent rate averaged from 1993 through 2000.

Again, we believe that restoring growth is the key to America's future—restoring growth while ensuring we have the resources in Washington to fight the war on terrorism, to provide for homeland defense and provide the services the American people want and need and demand. We believe the President's budget will help to ensure that both peace and prosperity are restored to the American people as soon as possible.

Mr. Chairman, that concludes my prepared statement.

THE PREPARED STATEMENT OF PAUL O'NEILL, TREASURY SECRETARY

Good morning Chairman, Chairman Conrad, Senator Domenici and members of the committee. Thank you for inviting me to testify today. Now that we've had a year to work together, you should know that I am an optimist about the United States economy. I believe we always have untapped potential that can be unleashed to spread prosperity throughout the Nation. Never has that been more true than right now. Even after a difficult year, my optimism about the fundamentals of the United States economy has not changed. I believe we were on the verge of recovery before the September 11 terrorist attacks, and that our resilience and determination have brought us back to the early stages of recovery today. We see more and more signs every day indicating that the seeds for a recovery are there, and only need nourishing to speed the process of putting Americans back to work. I believe we will return to prosperous economic growth rates of 3 to 3.5 percent, as soon as the fourth quarter of this year. I'm disappointed the Senate was not able to vote out a bill to speed job creation to more quickly return Americans to work.

Strengthening our economy must be our primary goal. It is the focus of the President's budget. That must be our goal, because a return to our normal growth rates means jobs for the 1.4 million Americans who have lost jobs during this recession. Just as a strengthening economy means greater prosperity for our Nation's people, it also means greater strength for our government. It means greater revenues going into the Treasury, without raising taxes, giving us resources to address the Nation's needs, and the retirement of even more Federal debt—leading to long-term economic security for our children. Even with all that must be done to enhance our security, we expect that a return to economic growth will bring us back to government surplus in 2005.

The economy's slowdown began in mid-2000, when GDP and job-growth slowed sharply. Business capital spending began to plummet in late 2000, and accelerated its decline in 2001, dragging down the economy. In August we were beginning to see the evidence of an economic rebound. I firmly believe that had it not been for the terrorist attacks of September 11th, that we would have seen an end to the economic downturn and would perhaps have avoided a recession. The September 11 attacks created shockwaves that rippled throughout all sectors of the economy. Financial markets were shut down for almost a week. Air transportation came to a standstill, As a result, GDP fell 1.3 percent at an annual rate in the third quarter.

By late November, the National Bureau of Economic Research declared that the United States was in a recession. They designated the end of the previous expansion to be March 2001, but they observed that the slowdown might not have met their qualitative standards for recession without the sharp declines in activity that followed the terrorist attacks.

In sum, the scorecard for the economy in 2001 reflected a combination of adverse events:

The private sector lost more than 1.5 million jobs.

The unemployment rate rose 1.8 percentage points.

Industrial production was off nearly 6 percent during the year.

Industry was using less than 75 percent of its capacity.

As bad as these numbers are, they could have been worse. Our well-timed bipartisan tax relief package put $36 billion directly into consumers hands in the late summer and early fall, providing much needed support as the economy sagged. It was the right thing to do, at just the right time.

It's not surprising then that both the Congressional Budget Office and the Office of Management and Budget project deficits for this year and next as a result of the economic slowdown and the response to the September 11 attacks. Last April's budget forecast a fiscal 2002 surplus of $283 billion. The Mid-Session review figures, released in August, took account of the impact of the President's tax relief package and projected a $195 billion surplus in fiscal 2002. The new budget forecasts a fiscal 2002 deficit of $9 billion, assuming no policy action to stimulate the economy. The reduced surplus estimates are the result of the economic downturn and the response to the September 11 attacks. CBO's projections confirm that tax relief played a minor role in the surplus decline in the next few years—accounting for less than 12 percent of the decline in 2002 and less than 28 percent in 2003.

	FY02 surplus (in billions)
April 2002 budget baseline:	$283
Changes from:	
weaker economy/technical changes	-197
enacted spending	-54
tax relief	-40
February 2003 budget baseline:	-9

The CBO budget projects a 10-year surplus of $1.6 trillion. Last August, after factoring in the tax relief package, the CBO projected a $3.4 trillion surplus for the next 10 years. The recession and the war on terrorism depleted the 10-year projections by $1.8 trillion. The lesson from these numbers is simple—10-year projections are a useful discipline but they do not predict the future. None of last year's 10-year estimates foresaw the events of September 11 or a negative $660billion worth of "technical changes" that are now included in the new 10-year estimates by agreement among the technical experts. We do know about the here and now, and we should deal with the here and now, reigniting growth to restore long-term surpluses.

The Administration's growth projections are similar to the consensus of private forecasts. Over 90 percent of the Blue Chip Economic Indicators panel members say the recession will end before April of this year. We share that assessment. Personally, I am optimistic that the economy will do even better than our budget assumptions suggest. For the near term, we expect the economy to grow 2.7 percent during the four quarters of 2002. That projection includes the foreseeable effects on the economy of the President's economic security package.

The lesson is clear. A strong economy is crucial to restoring budget surpluses. Some would suggest that we need surpluses to improve our economy. They have the logic backward. Growth creates surpluses, not the other way around.

The Federal budget was in deficit every year from 1970 through 1998. From 1970 through the early 1990's, government spending growth exceeded government revenue growth by ¾ of a percentage point a year, on average. Fiscal discipline was imposed by the historic *Omnibus Budget Reconciliation Act*, signed in 1990 by President Bush. With fiscal restraint made an integral part of the budget process, once the economy took off in the 1990's, revenue growth was double the pace of spending growth. It was the rapid economic growth of the 1990's that generated the burgeoning budget surpluses, which appeared even as Federal outlays grew about 3.5 percent a year from 1993 through 2000.

Today the economy is recovering. The tax cut of last May helped to keep the economic downturn shallow and it will continue to help. Energy prices have retreated. The Federal Reserve has reduced short-term interest rates 11 times since the beginning of 2001. Measures of consumer confidence are bouncing back. The index of leading indicators increased sharply in December for the third straight gain. Motor vehicle sales have remained strong. And initial filings for unemployment benefits are in decline. But we all know that unemployment itself is a lagging indicator. Although the current trend is positive, too many people will remain out of work. And given the choice, they'd rather have a regular paycheck than an unemployment check.

The President has presented a budget to speed our recovery. First, the budget includes tax relief to stimulate job creation as a crucial tool to speed our recovery and put Americans back to work. The President's proposals—accelerated depreciation, speeding up the reduction in the 27 percent income tax rate, reducing the corporate AMT, and checks to those who didn't benefit from last summer's tax rebates—enjoy bipartisan support in both houses of Congress. I'm eager to work with all of you to complete work on a package to create jobs and assist dislocated workers with extended unemployment benefits and temporary assistance with health care.

Second, the President's budget proposes strict fiscal discipline—increasing spending for national security and homeland defense, and holding the line on other spending. His management agenda calls for performance measures to be used to determine where budiget increases are allocated—so that our resources go into the projects and programs that make the biggest difference in people's lives. As the experience of the 1990's shows, this discipline in crucial to ensuring we do not return to systemic deficits of the past. But fiscal discipline alone will not guarantee budget surpluses. We must return to 3 to 3.5 percent annual growth to ensure surpluses for years to come.

The focus must be on restoring growth. Surpluses will then follow naturally. Raising taxes would stifle the process of getting Americans back to work. This is a bad idea, as our recovery is struggling to take hold. According to 1999 data, the most recent available, 33 million small business owners and entrepreneurs pay taxes under the individual income tax rates. They have made business plans that assume that the tax relief enacted last summer will take place as scheduled. Eighty percent of the benefit of cutting the top two rates goes to small business owners and entrepreneurs. These are the engines of job creation in our economy.

Tax relief should be accelerated, as the President has proposed to boost job creation. Such relief will have minimal, or no, effect on long-term interest rates. According to a recent analysis by the CEA, an expected $1 trillion change in the public debt over 10 years would tend to raise the long-term interest rate by 14 basis points. Since the tax cut last year, the 10-year nominal rate has averaged 4.93 percent, which is substantially below the 6.16 percent averaged from 1993 through 2000.

Restoring growth is the key to America's future. Restoring growth is the key to ensuring we have the resources in Washington to fight the war on terrorism, provide for homeland defense and provide the services the American people demand. The President's budget will help to ensure that both peace and prosperity are restored to the American people as soon as possible.

Chairman CONRAD. Thank you very much.

I am going to defer my opening questioning and go to Senator Byrd on our side, and then we will come back for Senator Smith's determination of who will go first on their side.

Senator SMITH. Mr. Chairman, since I made an opening statement, I will defer my first questioning round to Senator Allard.

Chairman CONRAD. All right.

We will start with Senator Byrd on our side.

Senator BYRD. Thank you, Mr. Chairman.

Thank you, Mr. Secretary.

On page 51 of the first volume of the President's Budget, I noted the picture of Gulliver being tied down by the Lilliputians. Here it is. The caption beneath it reads: "Many departments are tied up in a morass of Lilliputian do's and don'ts."

This is not the first time that the Administration has invoked the word "Lilliputian" when referring to the priorities of Congress. It makes me wonder if the Administration may not be requiring the members of the Cabinet to read Jonathan Swift's masterpiece of satire.

Last year, before the National Association for Business Economics, Mr. Secretary, you used the word "Lilliputian" in referring to the application of the Byrd rule on reconsideration bills. You were quoted as saying: "The rules that have been created by just ordinary people are in some ways more and more like the Lilliputians tying us to the ground. I do not know why we have to live by these rules; after all, so far as I can tell, God did not send them."

Inasmuch as you have invoked the name of the Creator, I would say that God works in mysterious ways his wonders to perform. This is not my quotation, but he does. He believes in rules, too. He gave them to Moses on Mount Sinai—the Ten Commandments. They hang in my office. Those are rules. I feel that God had his hand upon the destiny of this country when those illustrious men gathered in Philadelphia to create the Constitution of the United States.

I do not know whether or not you have read Catherine Drinker Bowen's book, but she says that "At no other time could these men have written this Constitution, which has proved to be the earliest written Constitution in the world and the most successful one." She says that 5 years earlier, the people and their representatives who were at the Convention would not have experienced enough of the disadvantages or the shortcomings that they needed to have experienced to have written this Constitution. She says that were it 5 years later, the people would have been turned off by the French Revolution and the sound of the guillotine.

So the clock struck just at the right time. As far as I was concerned, that was God's hand, if you want to invoke God's name; that was God's hand at work.

You said “The rules that have been created by just ordinary people”—the rules, Mr. Secretary, of the Senate have only had 7 revisions in the more than 200 years of the Senate’s history. Their roots go back into the House of Commons in Great Britain. Their roots go back to the Continental Congress. Their roots go back to the Confederation.

We are using rules of which the first 20 were written within the first 10 days of the Constitutional Convention’s meeting. Those are rules.

Let me tell you what Thomas Jefferson says about rules. Let us compare it with what you say. You said, “The rules that have been created by just ordinary people are in some ways more and more like the Lilliputians tying us”—now, who is “us”—“tying us to the ground. I do not know why we have to live with these rules; after all, so far as I can tell, God did not send them.”

Well, Mr. Secretary, I say with all due respect—and I have great regard for you—that you seem to have gotten off the track. You probably should have had a good study course in American history before you came here—I am not talking about the kind of history that comes up with cartoons like this. Many of the so-called history books of our present time are full of colorful cartoons just like this. They do not teach real history.

I read Muzzi back in 1927, 1928, 1929, 1932, David Seville Muzzi. That was history. There were pictures. Now, you say, “The rules that have been created by just ordinary people”—these were not ordinary people, the men who signed the Constitution. They provided for the rules of the Senate.

The Congress and certainly this Senate is not ordinary, and it is certainly not Lilliputian. We are Senators. I have been before the people at the bar of judgment 29 times in these 50 years, counting this year, that I have served in Congress—29 times. I have taken the oath to support and defend this Constitution 16 times.

I am not asking you to answer this question—but how many times have you been before the bar of judgment of the people? In what elections did you run in order to represent the people? You were appointed. We were elected by the people, directly by the people—not like the President, indirectly, by electors who were elected by the people—we were directly elected.

Chairman CONRAD. Senator, if I could say, I grant 7 minutes and my first round of questioning to the Senator so he can continue in his statement.

Senator BYRD. Mr. Chairman, I thank you, and I will not dwell upon this any longer except to say that we are Senators, and you have been in this town 1 year. I have been in this town 50 years. I have seen many Secretaries of the Treasury. And I just want to tell you that we Senators are here to look after the interests of the people of our States. They are not well-to-do people—not all of them—in my State. They are not CEO’s of multi-billion-dollar corporations. They cannot just pick up the phone call a Cabinet Secretary.

In time of need—in drought, in floods, in famines, when a bridge is near collapse, when safe drinking water is not available, when health care services are endangered—they come to us. The people come to us. Yes, they are ordinary people. They are coal miners, they are farmers, they are schoolteachers, they are ministers, they are lawyers, they are bankers.

This cartoon on page 51 and comments throughout this budget suggest that this Administration believes that so-called experts at bureaucratic agencies should determine the priorities of this Nation—not the Congress, not the people they represent. That suggests that the problems of the people are too little to deserve the attention of the Administration.

Here is what the paragraph says by Dr. Gulliver: ". . .it is critical that the government operate effectively and spend every taxpayer dollar wisely. Unfortunately, Federal managers are greatly limited in how they can use financial handling and other resources to manage programs. Federal managers lack much of the discretion given to their private sector counterparts to get the job done."

We have seen what discretion given to private sector counterparts has done. We saw that in Enron.

This budget, wrapped in the American Flag, says: "Government is ineffective under these conditions. During wartime, turf protection cannot dictate the national interest. The Congress should remove barriers and give the Administration the tools to do the job that must be done."

So you say the Federal managers are greatly limited in how they can use financial resources. That is a good thing. These people, the so-called Federal managers, are not elected by the people, and we are talking about the taxpayers' dollars—the taxpayers' dollars. That is why there are rules. That is why we have rules.

So you say "Federal managers lack much of the discretion given to their private sector counterparts." Yes, because they are dealing with tax dollars, the American people's dollars.

My question would be does this kind of nonsense belong in a budget document. Now, to be fair, if we are going to do that, let us have a little more fun. Why not refer to the territory that was called Brobdingnag. Swift also wrote about that. Dr. Gulliver visited Brobdingnag, where there were not pygmies, but giants as tall as church spires, and with respect to one step of those giants, that step covers 10 yards.

I would refer to this since we are in the business of using Swift's satire. This budget is a Brobdingnagian budget, a Brobdingnagian budget. Not bad.

If we want to continue this, we can do it after the meeting. I have been very generously given time at this point.

I just want to remind you, Mr. Secretary, that a lot of us were here before you came, and with all respect to you, you are not Alexander Hamilton.

I have a question. Steel company representatives and steel workers have worked through numerous hurdles and made a number of concessions to reach consensus on a plan to renovate the United States steel industry. They have let the Administration know that in order for this plan to work, the President needs to conclude the Section 201 investigation of steel importation at the earliest possible date, with a remedy of nothing less than a 40 percent tariff on steel imports.

In addition, the steel companies and workers have asked for the Administration's help in removing barriers to steel industry consolidation in the United States and in relieving the costs to the maximum extent possible of health care and pension benefits to retirees.

Steel industry representatives from my own State have expressed optimism that this Administration is working positively with them to advance such a multifaceted solution. In light of this very critical time for the steel industry and this window of just a few weeks that could mean a turning point to a revitalization of bankruptcy and collapse of an industry that ties under our national security, this Administration submits a budget that cuts the steel loan guarantee program by $96 million.

I find it hard to share in the optimism, and I will just ask one question at this time, and I will have further questions that I will submit.

What can you tell this Committee specifically about this Administration's intentions with regard to helping the steel industry with tariffs, reorganization, and legacy costs?

Secretary O'NEILL. Well, Senator, what I said to the National Association of Business Economists, I stand by, because what I had in my mind and what I deeply believe is this—that where we have rules made by men that restrict the realization of human potential, they should be changed.

We had rules that said, "Colored, do not enter here." That was a manmade rule. And there are lots of those same kinds of rules that limit the realization of human potential, and I have dedicated my life to doing what I can to get rid of rules that so limit human potential, and I am not going to stop.

Senator BYRD. Mr. Secretary, I have been around for a long time, and I try to live with the rules. You were specifically talking about the Byrd rule.

Secretary O'NEILL. I was talking about all rules that limit human potential and the realization of human potential, and referring to something different is fine if you wish to do so, but I would also like to say, because there was an inference in your remarks that somehow I was born on home plate and thought I hit a home run—Senator, I started my life in a house without water or electricity. So I do not cede to you the high moral ground of not knowing what life was like in the ditch.

Senator BYRD. Well, Mr. Secretary, I lived in a house without electricity, too, no running water, no telephone, and with a wooden outhouse.

Secretary O'NEILL. I had the same.

Senator BYRD. I started out in life without any rungs in the bottom of the ladder. I am talking with you about your comments concerning the Byrd rule and the people who wrote these rules. I am not talking about putting a halter or a break on anybody's self-incentive or anybody's initiative. I have had that experience, and I can stand toe-to-toe with you. I have not walked in any corporate board rooms. I have not had the churning of millions of dollars into trust accounts.

I lived in a coal miner's home. I married a coal miner's daughter. So I hope we do not start down this road, talking about our backgrounds and how far back we came from. I am citing to you what you said in response to a question about the Byrd rule. The Byrd rule has saved millions and millions and millions of dollars for this Government, and we ought to live up to it.

Perhaps you ought to study the Byrd rule a little bit if you have not to the point that you can explain it. And just remember, the rule that I am talking about, those ordinary people—you are talking about Senators. They are ordinary people, and they are not going to let you get away with it. We are not going to let you get away with it.

So if you want to answer my question on steel.

Secretary O'NEILL. All right. As you know because you have been in some of the meetings that we have been having on the subject of steel, we began last year to see if it was possible to create a basis for the world to adjust the arguably 30 percent overcapacity that the world today has in steel, and through the President's efforts and administration work, we succeeded in getting the OECD to provide a structure for calling together the principal producers of steel in the world to try to get them to stipulate the need for capacity reductions, especially of capacity that is exporting its goods around the world with Government subsidies and undercutting the ability of almost any steel company in the world to make enough money to cover the cost of its capital, as a piece of a concerted, connected set of ideas about how we should proceed in this area.

Subsequent to beginning that work, the President filed a 201, and he has until March 6, I believe, to make a final decision on what level, if any, and kinds of combinations of tariffs and impositions he should put on imports in the United States to make sure that the world is fair in the way that we provide a basis for our own steel industry to make a living. There are day-by-day conversations going on to this issue of what tariffs or barriers or provisions should be imposed on the rest of the world, and as I say, the work will be done by the appointed date of March 6.

Senator BYRD. I hope the President will act and act immediately and act forcefully. He was in West Virginia and told the steel workers that he would help them. The Vice President certainly was in West Virginia and told the steel workers he would help them. West Virginia went for Mr. Bush, else you would not be sitting there today if my State had gone for Mr. Gore.

So the steel workers are hoping and praying that the President will act and act immediately to help them in this regard.

Thank you very much.

Chairman CONRAD. Senator Smith.

Senator SMITH. Mr. Secretary, I was looking at your resume, and I believe you started your professional employment as a civil servant for the Office of Management and Budget. Is that correct?

Secretary O'NEILL. In fact I started at the Veterans Administration as a computer systems analyst in 1961 and completed my previous Government service at the office of Management and Budget as deputy director in 1977.

Senator SMITH. And you have served in the administrations of Gerald Ford, is that correct——

Secretary O'NEILL. That is right.

Senator SMITH [continuing]. And President——

Secretary O'NEILL. Kennedy, Johnson, Nixon, and Ford.

Senator BYRD. Would the Senator yield to me?

Senator SMITH. I would be happy to yield, Senator Byrd.

Senator BYRD. Since we are talking about how many administrations we have been in——

Senator SMITH. You can beat us all, I am sure.

Senator BYRD. I have served with—not under—11 Presidents.

Senator SMITH. Well, I have great respect for Senator Byrd. I feel badly, though, if you feel demeaned appearing before this Committee in any personal way, because I just want to say again for the record as I did in my opening statement that you did not need this job, but you are doing a fine job, and I believe you have served in many administrations, and you left a very lucrative position because you wanted to make the world a better place. And I think that needs to be said again. So I——

Senator BYRD. Would the Senator yield?

Senator SMITH. I would be happy to yield to Senator Byrd any time.

Senator BYRD. May I just add a little footnote along that line?

Senator SMITH. Of course.

Senator BYRD. I do not need to serve here, either. I believe I could retire and get more money in retirement than I earn as a Senator. I am talking about my retirement from the years I have served in Government.

Senator SMITH. I understand that.

I thank you, Secretary O'Neill, for your service to your country, and I thank Senator Byrd for his service to our country as well.

Mr. Secretary, I also had in my opening statement an ongoing concern about the uninsured in our country, and I note that in the budget, the President is proposing $89 billion for the uninsured. I think that anticipates insuring an additional 6 million Americans.

There are many ideas out there for how to do even better. I think this is a good beginning, but I wonder if you have in mind anything additional that we might look at on this Committee as we authorize the going forward of trying to eliminate this moral omission on our country's part. Expansion of Medicaid, SCHIP, as well as incentives to small business, expanding community health centers—all of these things—are there some ideas that you have and some direction that you might give us for how to do even better than eliminating 6 millon from the rolls of the uninsured?

Secretary O'NEILL. This is really a very complicated subject. What I would like to do, if Committee members are interested in doing it, is I would like to organize a field trip to take you all to Pittsburgh and show you the future of how we can reduce the cost of medical care by 50 percent and stop hurting people in the practice of medical care and thereby free up the funds so that we do not have this problem of people without health insurance, because we will be able to afford it.

There is a way to do that, and there are a few other places in the country where the work is going on to demonstrate that it is possible, for example, to eliminate people getting staph infections, what are called in the medical profession pneusacomeal infections in the hospital, which affect maybe 7 percent of inpatients in United States hospitals—just something that the hospital did not bring with them that raises the cost of their medical care.

There is a set of ideas that, practiced together, can produce this result. And I think that if you are looking for the single largest potential thing to do that will result in the effect that you are looking for, in effect, providing health care access for every American citizen, that the road by which we are going to get there.

I would say—you mentioned Medicare and Medicaid—I think that all the things that have been done here since 1965, when these two programs were enacted, were done with good intentions and the best wishes for the population. It is unfortunate that so many of them have turned out to have had perverse effects, partly because the mindset that is brought to this subject from Washington is one that has in it the idea that if we do not treat medical care providers as though they are trying to rip us off, that in fact they will rip us off—and the consequence of that is indeed perverse, because it has led to reimbursement formulas that put the pressure and incentivize, for example, discharging patients against a statistical profile that says, for example, for bypass patients, it is on average 5.9 days for people to be discharged, and so our formulas provide economic ways to get people out of the hospital after 5.9 days. If you look at the data, what it tells you is that 20 percent of the people who are discharged before the statistically suggested number are readmitted to the hospital the next week, and a fair number of them die.

Now, from the reimbursement formula point of view, we do not care, because manage to incentivize the target of getting patients discharged, and since we do not really pay attention to patients—we pay attention to episodes—our system drives us in a direction that is not about human value—and this, for example, Senator Byrd, is the kind of manmade rule that I have in mind when I am out there trying to change the way the world works. We created these rules that are anti-human being with the very best of intentions, and Medicare and Medicaid reimbursements, and they need to be changed by human beings, and they are only going to be changed as we reformulate how we think about the potential and the realization of higher levels of human enjoyment.

Senator SMITH. Mr. Chairman, I would suggest that we take the Secretary up on his idea of a field trip. I think it would be very helpful to have better in mind as human beings on this side of the table how we can cut through some of the red tape to actually help our citizens and close the ranks of the uninsured.

I just think it is an ongoing national shame that we are not finding more creative ways to address this system of health care delivery.

I only have one other questions, Mr. Chairman, for Senator Domenici, who asks: When will we breach the statutory debt limit?

Secretary O'NEILL. Before the end of March.

Senator SMITH. Before the end of March.

Thank you, Mr. Chairman.

Chairman CONRAD. Can I just say that on the offer that the Secretary made, your staff director informs me that it would have to be on Treasury's nickel, because we are out of money.

Senator Corzine.

Senator CORZINE. I guess that is appropriate for the Budget Committee. We are being very astute here.

Mr. Secretary, I welcome you. I also, though, want to express sympathy with the context that sometimes I think in this political world that we live in, we use cartoons or label people obstructionists when they are really trying to do what is perceived as their rightful responsibilities and certainly their prerogatives and instructions. I think that sometimes the dialog covers up well-meaning people's intentions on a lot of things. So I know that we may have some differences of view about exactly how we look at this budget, but in the long run, we have to have the good will to understand that we are all looking after the same end product for the American people, and that is why we all are serving.

In that light, I have serious concerns about the structure of our budget. It is troubling to me that even off the numbers we see, we are going to be using about $1.6 trillion from the Social Security surplus numbers, the payroll taxes, if I read these numbers right, running a unified budget deficit—a non-Social Security deficit—of $1.5 trillion over the next 10 years. I have a hard time understanding how we are going to be able to deal with the demographic bubble that is acknowledged by everyone, and I understand the administration and many have proposed the privatization of Social Security. That is not allowed for in this budget, and by any reasonable analyst, that is going to be a trillion-dollar transition cost—maybe $800 billion, maybe more.

I am troubled that we are working off of numbers that are not realistic with regard to how we are going to deal with the budgetary requirements and limitations that we have as a society going forward, and particularly, then, when we put it into the context of many things that I could talk about, whether it is with regard to the environment, health care, other issues that I think we need to seriously address, including our national defense and homeland defense.

I am going to talk about one today; it is a small item, but I think it is very important in the context of the debate that exists in America today, that concerns the American people. It deals with the SEC budget. The SEC budget is not up at all this year, if I read these numbers right. It fails to include funding to bring pay and benefits for SEC employees up to levels that are equivalent of other regulatory agencies. And here, we have an incredible debacle, I guess is all you can actually label the Enron situation, but those of us who were in business also know that we have had more restatements of accounting statements of earnings in the last 2 years than we have had in the previous 10 years combined. We know that the SEC, which has responsibility—ultimate responsibility—for supervising this, does not have the resources. We have 22 accountants—I think that is the number—in the Accounting Division of the SEC and a responsibility to supervise 3,000 public companies.

I do not understand how our priorities, given that we need to be able to have the efficacy of sound reporting and supervision of our securities markets, which are so fundamental to the raising of capital to the saving for pensioners and investors across this country, one of the fundamental dynamics—how we can be so limited in our investment in something that is absolutely essential to a strong economy.

As a matter of fact, I am very fearful that while some of the members are looking good with regard to our economy now, we will see foreign investors and others losing confidence in America because they cannot interpret what it is we report in our corporations when we see changes in behavior of lenders and other investors.

So, while it is a small piece, I think it is a very important piece in the current context of how the American economy is working, and I think it is indicative of this overlay of a program. Fundamentally, I think the tax cuts have a lot do with that, of how we are not prioritizing the kinds of things that will make America strong.

And so I would love to hear your comments both about the privatization of Social Security and the transaction costs, which are completely left out of this budget, which we know have to be inputted, if that is the direction we take. I am not sure I would be supporting that. But how can we justify the kind of thing with regard to providing the security for our financial markets that I think is necessary for a sound financial system?

Secretary O'NEILL. Thank you very much.

If I may, let me couple my answer to your questions with Senator Conrad's opening statements because he also talked about Social Security, and I think it is worthwhile, at least it seems worthwhile to me, to talk about the concept of where we are.

You know, as I have appeared now eight and a half hours before three different Committees or four different Committees over the last couple of days, we have had ongoing conversations on every Committee about Social Security, and there are so many times when members say we are taking money out of Social Security. Well, we all know that is not right.

And, again, to the issue that I was raising earlier about rules, and concepts, and the importance of getting them right, we all know that the trust fund is not a trust fund in the way you would understand it as a trust fund for your own children, which has real assets in it, and that is not to say that a piece of paper from the Government in a lock box from West Virginia is not a real asset because it is a real call on the future earning power of the country. So, in that sense, it is a real asset.

But I, frankly, think we do a disservice to the American people when we talk about the shameless action of taking the people's money that they send in here, which they earned with the sweat of their brow, and send in $4,900 or whatever for a couple and leave them with the impression that we took their money and spent it on something else when, in fact, we did not really.

We took it and bought Government securities and put them in a lock box in West Virginia, and then we said the total wants and needs of a country, from a cash-flow point of view, require more money than we have taken in for general revenue, so we are going to have to borrow some more money, and so we borrowed that money. We could, if you wanted to do a hand-washing transaction, we could go through the rigamorole of actually doing that, of buying and selling so that the cash is reflective of what is happening in the broader sense.

Now it does not gain your point about the long-term, unfunded liability that we have for the trust funds, and so I have been saying, because I think this is right, we should have a balance sheet that is a real balance sheet in the Federal Government, and if we had a real balance sheet, we would find on it $10.5- or $11-trillion worth of unfunded liability, and it would call our attention every day to the obligation that we have created for the American society, which one way or another, we have to take care of.

I think it would be very helpful to the debate and the people's understanding out there if they knew more precisely what this conversation was about, and we all stopped this, I guess it is a political conversation that really scares people out there. I know it scares people because I get letters from citizens saying I heard some Member of Congress say that you are using our Social Security money and maybe we are not going to get our payments. I do not think that is a healthy thing to do to people out there, especially when you see some of the people that are getting their checks, and they are in their upper years, and their hearing is not so good. And when they hear that maybe we are not going to meet our obligation in Social Security, it scares the hell out of them, and I do not think we ought to be doing that because that is not true.

I cannot conceive of a United States Congress or an administration that did not fulfill the obligations people believe we have under Social Security. So I think we ought to set that aside, and then we ought to deal with the real problem which is an unfunded liability of very large proportions.

Senator CORZINE. Well, we are making that unfunded liability larger when we do not set aside or pay down the debt, in my view.

Secretary O'NEILL. No, we are not. Excuse me. I am sorry, Senator.

Senator CORZINE. It is money, if it were set aside, that actually could be utilized to compound and grow to meet an unfunded liability. Now that is the argument that we have in the political arena, but the reality is we are using Social Security payroll taxes and Medicare to fund all of these other choices that we have today because we use a unified budget in this country. Money is actually, since it is fungible, it actually goes to the other purposes, and we are funding tax cuts, we are funding expenditures on some things that some of us like with those resources today.

Secretary O'NEILL. I, respectfully, do not agree with you, sir. What we are doing is we are using the Federal Government's debt capacity to pay for things that we want, which we are not collecting enough money, either through income taxes or payroll taxes, to fully pay for, and the other is an accounting illusion.

We are really using our debt capacity, and in this sense, if we were running "surpluses," on a nonunified basis, on a trust fund basis, we would be reducing debt outstanding held by the public, and that would improve the Government's balance sheet, but it does not have anything directly to do with Social Security, except to the degree that the more flexibility we have in the size of our balance sheet, in effect, to borrow money, we are better off than that not; is that not right, Senator Corzine? I mean, you are a financial guy like I am.

Senator CORZINE. We have a difference in view in the sense that if you set up what is called a trust fund and actually set those dollars aside, whether they are invested in Government securities or not, they earn an interest rate or they earn a yield, and they grow.

And if you set more of them aside, you have a greater opportunity to fund that unfunded liability than you would have otherwise.

Secretary O'NEILL. I agree with you, but that is not the way the system works today. By convention, by practice, by manmade rules, we do not actually put the money away, we put a piece of paper away.

Senator CORZINE. I agree with that, but that does not mean that it is not earning an interest rate. I do think that your point about us scaring and the political dialog, people, at least the current retirees, of their ability to get their benefits is a bad mistake.

Chairman CONRAD. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman, and I want to thank the Secretary for coming before this Committee. I think that you have a challenge ahead of you, and I, for one, respect your abilities and want to support you in every way I possibly can.

Secretary O'NEILL. Thank you.

Senator ALLARD. Argentina is having some problems there, and I know that the administration has been in contact with them and how to help out, and we have a number of issues that come up, and what is happened is one is dollarization and whether that would help or not. There are a couple of countries who have used dollarization and been rather successful. Ecuador is one that comes to mind. I think El Salvador is the other. And then you have the issue of how much should we come in and help them out through the IMF.

My hope, my personal view is that I hope that we can get some substantive reform within that country, the way they handle their banking system, the way they handle debt, before we give them any money. I just wish that you would kind of comment on that a little bit.

Secretary O'NEILL. Thank you, Senator.

First, to the issue of dollarization. I think, if you look back a year, you could have made a plausible case that the Argentineans could have dollarized a year ago because they had enough dollar reserves to convert and support the alternative pesos that they had pegged and said the peso and the dollar will always be worth the same amount. In about September, maybe late September, the reserves necessary to be able to do a direct dollarization evaporated, and it is not really a feasible thing for them to do any more. And so they are in the process of converting to a peso currency, a peso-based financial system in their country.

As you say, we have spent an enormous amount of time and are working with them, caring about them. They have had a succession of Governments. We want them to succeed, and I think this is not a partisan thing. In November of 2000, the Clinton administration supported an IMF program for Argentina, some $43 billion. In April, they had run through that, and we, the Bush administration, supported a further IMF program of some $20 billion, and by the end of August that was gone. And we finally supported an additional $8-billion IMF program, but as we did so, we said to the Government in power, you have simply got to change the way your system is working because it is not sustainable, and neither the American people nor the other support of the IMF are going to keep sending money as you fail to fix your system.

As an example of the problem they have in Argentina, they have a system where their provinces, the equivalent of our States, are able to make binding obligation that become the duty of the Federal Government without the Federal Government having an opinion. Now, if you can imagine having your own bank account and having hundreds of people with credit cards that can go out and write checks on your account, and you are responsible for paying it, that is the situation, in a way, that exists in Argentina.

They have a tax system that collects, today, it is maybe 40 percent of what the tax system is intended to collect. As they fell into this morass, they were in a position where they had $140 billion worth of outstanding debt and enough revenue to service maybe $70- or $80 billion, and so it was clear that this was not a workable situation any more.

Again, as I say, we have worked every day with them on a technical level. We have made it possible for technical experts from all over Latin America who have gone through these kind of things to be available to them on an accelerated everyday basis. I, myself, talked to Ramasses, who is the new finance minister. I have talked to him repeatedly. I talked to him the night before last, so we are indeed in touch with them and with the IMF.

We are dedicated to the proposition that this important country in our hemisphere needs to be successful. But I think there is one important proviso. We can help them, but we cannot help them until the sovereign Government establishes rules and procedures that give them some chance of stability. It is not something we can impose from outside. It is something they must do for themselves.

Senator ALLARD. Well, I am also concerned when I see, you know, countries like that, they devalue their peso, and then it makes it more difficult for us, for example, to compete on the agricultural sector. They produce a lot of agricultural goods, and I think it has, to some degree, some impact on our ability to expand our export markets in an agricultural area.

Let me switch a little bit over to Government GSE's. These GSE's we have two right now, Fannie Mae and Freddie Mac, and my understanding is that they carry a considerable amount of debt in both Fannie Mae and Freddie Mac. The Government does not own any interest, any stock in it, but we have a lot of investors who do, and I think sometimes they feel that there is an implicit guarantee there that the Treasury will help them out if they get into trouble or even the Congress.

Now a CBO study entitled, "Federal Subsidies in the Housing GSE's," published last year indicated that this subsidy amounted to $6 billion in 2000. I wonder just what your thoughts are on GSE's and how we should account for the debt in some of our thinking.

Secretary O'NEILL. Let me say, first, on the consequence side of the GSE's, I think if you look at what has happened with a Fannie Mae and a Freddie Mac, it seems fairly clear if you look at the experience of other countries, that these financial intermediaries have played a really important part in bringing higher levels of homeownership to the American population than they otherwise would have had.

As a matter of fact, this all started, in a way, in 1935, when Franklin Roosevelt, under his leadership at least. There was a change in the expectations—again, this is kind of an unwritten rule that existed that if you wanted to buy a new house, you had to be able to pay it off in 5 years, and basically you had to have cash to buy a house, and the invention of just an idea—this is the importance of ideas—that people could be trusted to pay their mortgages over 20 or 30 years revolutionized homeownership in the United States.

Freddie and Fannie have been a part of that, and I think they are really a credit to going back as far as 1935 to the maturation of those institutions and to intermediaries that really do not exist in the same way in other countries.

People have become more concerned that they have grown, and I think, as we observed in the book, and the number is not perfectly in my head, but they have now got something on the order of $1.4/$1.5 trillion worth of debt. Importantly, it is all collateralized by holdings. It is not as though it were supporting speculative commodity trades or something. It is a much more solid foundation than what you find in most any other institutions because it is so much a part of the life of the people who were on the other end of the debt instruments. So I do not think it has the risk associated with it. As long as the loan origination process is good out there in the country, they should be OK.

But it is something that we have looked at, and I continue to look at and to wonder whether it is not time for some new ideas about these organizations work. It is true that I think under current law they have access to something on the order of $4 billion from the Treasury, but when you look at the size of their activity, it is clear the $4 billion is not mapped in their universe.

Some in the financial markets argue that the $4 billion is really a marker for the idea that they are too big to fail and that ultimately the Federal Government must and would stand behind them in case there were a substantial collapse underneath Freddie and Fannie assets.

So it is something we are continuing to look at. We are aware of the concerns that people have, and we are looking with them to see if there are ways that we could reduce the anxiety that people have without hurting the process of homeownership accumulation in the country. Because as a social value, we think it is a very, very important thing that people, where they have a financial wherewithal, are facilitated into homeownership.

Senator ALLARD. I appreciate your response to that because that is getting more discussion. I think your thoughts needed to be heard, and I appreciate you sharing them with the Committee. I agree with you that homeownership has been kind of the thing that has kept our economy going during these times. It is the bright spot out there, and we want to be sure that we do not disrupt that.

Mr. Chairman, if you would allow me, I would like to have one other question that I would like to place to Secretary O'Neill, and that has to do with the way that we look at Government, the impact of a tax cut on our revenues. I come from the State of Colorado. We use dynamic scoring. So we are capable of doing, and I think obviously that gets some discussion on how you are going to put it together, but it seems to reflect, in my experience, more correctly what happens with the budget when you cut taxes or increase taxes. We are a State that is known as a State that is pretty responsible with taxpayer dollars and whatnot. We do not—we are conservative in that regard.

I am stymied that somehow or another you can make this work at the State level, but somehow or the other, the Federal level refuses to look at that dynamic scoring as a way of evaluating tax cuts or tax decreases. I think, frankly, that the way the process works now, it is prejudicial against tax cuts because it, somehow or the other, implies that there is going to be less revenue, where many times, in real terms, it ends up being an increased revenue.

So I wish you would talk a little bit about whether you have any idea on how we may bring about dynamic scoring within the Federal Government.

Secretary O'NEILL. I appreciate the question, and I quite agree with you that it would be helpful if we had, and provided agreed that we would have a regular access to both static and dynamic scoring.

You know, again, it is an area where I think we are bound by the conventions that we have adopted, and it is almost as though you would say to a carpenter, you know, you only get one tool, and it is a hammer, and if you need a screwdriver, you will have to figure out how to put the screw in with a hammer, which we all know is possible, but not particularly desirable.

And so I, frankly, think not only in this area of scoring, but on broader issues of how our budget conventions work, that there would be real utility in looking together at other changes that might be considered as we do this important work that ends up in resource allocation decisions. I think maybe it is time to take a look and see, in addition to dynamic and static scoring, whether there are not some other things that would be beneficial to all of us and to the American people as we try to do their work.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. We have been liberal on both sides here, in terms of use of time, and I think that was fair, given the numbers of people here and the importance of the questions being raised.

Let me take my time now in questioning. I know that you got a little exercised earlier——

Secretary O'NEILL. No, not really.

Chairman CONRAD. I get a little exercised listening to you.

You disagreed with a statement that many of us have made that the Federal Government is taking Social Security money and using it for other purposes. You said we all know that is not true. I do not know that is not true. In fact, I believe that is exactly what we are doing. I believe it is clear from the Government's own documents that is what we are doing. I have got an OMB document here that they sent up with the President's budget that says exactly that. It says we are taking about a trillion and a half of Social Security surpluses over the next decade. We are taking those dollars and using it to pay for other functions of Government.

Let us just put this up. It is confusing to people. I will grant you, and you say the system works a certain way today. That is true.

Some of us have said we have got to change the system because we are headed for a train wreck. I think that is undeniable.

Here is what happens today. A taxpayer sends his payroll taxes in, they get credited to the Social Security Trust Fund. That is absolutely true. And there are Treasury, special Treasury documents, bonds, that are assets that are being held in a vault in West Virginia that say the Federal Government will repay those borrowings in the future, and you are exactly right that that is going to have to be paid out of the future revenue flows of the Federal Government. We are in agreement so far.

When the money gets credited to the trust fund, some of it goes out to pay current Social Security benefits. I think we would all agree with that. To the extent that those funds are in surplus today and are not used for other purposes, they go to pay down debt. That is why last year you were telling us we would be paying down some $2 trillion of debt over the next decade because Social Security funds were in surplus and were not being used for some other purpose.

You could also use that money to prepay liability. We are not doing that.

There is a another alternative. We could take that money, and this is what is being done, unfortunately, in large measure. In fact, 100 percent of the surplus is now being used to pay for tax cuts and other programs of Government, and, to me, it is undeniable. You say it is a disservice to the American people to say so. I think it is a disservice to the American people not to say so.

My own view is it is necessary, but not sufficient, to save all of the Social Security Trust Fund dollars for Social Security now, but actually do more than that. In the budget I proposed last year, I actually transferred $900 billion of general fund money to start private accounts as a way of prefunding liability because we are headed for this train wreck.

Last year, you seemed to think protecting Social Security had some merit and said it was being done, and I would go back to this quote. You said this in the Finance Committee, "The Social Security dollars that are going to flow into the Government over the next 10 years are safeguarded, lock-boxed, fenced off, protected. I do not know if there are more strong ways to say it. Social Security dollars are set aside without any threat of encroachment." Now that has proved not to be the case.

Secretary O'NEILL. I think that is still the case.

Chairman CONRAD. Well, I do not. The only way you can make that argument is that the money is being credited to trust fund. Is that the argument that you make?

Secretary O'NEILL. It is. And if you would put up the other chart, I would introduce one more box.

Chairman CONRAD. Yes.

Secretary O'NEILL. Actually, what happens after the Social Security Trust Fund flow, the money goes into the cash accounts of the United States, and if you do a full depiction, the money is going to support the troops in Afghanistan, and the money is going to pay for HIV programs, and the money is going to pay for biomedical research, and the $50 billion worth of education we are going to——

Chairman CONRAD. Right, all kinds of meritorious purposes. But the truth is it is being taken to pay for other things. Now, look, there is no private sector firm in America that could take the retirement funds of its employees and use it to pay operating expenses of the company.

Secretary O'NEILL. They have real trust funds.

Chairman CONRAD. They have real trust funds.

Secretary O'NEILL. Right.

Chairman CONRAD. Some of us would argue, at this stage in our history, we need real trust funds, and I think the fundamental problem, the disconnect here is I believe that we are in just a different time than where we have been. We have never faced a demographic situation like the one we face today. We have got a demographic time bomb. Always before the succeeding generation was smaller than the one coming on. Now we have got this circumstance where everything is going to change, and yet we are running the railroad the same old way.

And so I must say that I just profoundly disagree when you say that we are not taking Social Security money and using it for something else. I think that is exactly what is going on. Now that is the way the system is set up, but I do not think the system is going to work in this current circumstance, and it leads us—could we get Director Crippen's quote because where is all of this leading us to? It is leading to choices for a future Congress and a future President that Director Crippen described, and I think this is an accurate description—either huge taxes increases, dramatic cuts in benefits or massive debt.

Do you agree or disagree with his characterization?

Secretary O'NEILL. I do not think that is the full range of choices. I think there is, in fact, a way for us to transition into a system that is worthy of building on Social Security to an even better idea, which is that every American, when they are 65, should have accumulated a million dollars' worth of money that they own in their own name, and with the amount of money that we are now collecting from individuals and families through Social Security, if that money were collected from age 18 to age 65 and invested at market rates of interest, it is not beyond the possibility that we could deliver an American society that rises to the level of people being independent when they are 65, not dependent on a promise from the Federal Government.

Chairman CONRAD. But there is a cost.

Secretary O'NEILL. And it is——

Chairman CONRAD. There is a transition cost.

Secretary O'NEILL. The costs associated with that is paying off the accumulated liability that we have accumulated over the last 67 years, which our economic bounty, I believe, will permit us to do if we have the courage to think it.

Chairman CONRAD. Well, let me just say that I do not disagree that there is enormous potential, but the money has got to come from somewhere. And right now, under the President's plan, you are taking the money that could be used for that purpose, and you are spending it for all kinds of other purposes, and it is not available for that purpose.

And the argument I hear from the administration is, well, we have got a recession and a war, and that is the reason we have had to back away from the clear pledge made by the President, the administration, the clear commitments that you were making last year. Look, I could accept that at the time of recession. Actually, the cost of the war is not the biggest part of the problem. But, goodness, you are not forecasting recession next year. You are not forecasting recession the next year or the year after that or the year after that, but you are taking the Social Security Trust Fund dollars in every single year of this decade.

Secretary O'NEILL. If the Senate or, actually, if the Congress does not proceed to spend the money that was decided yesterday not to spend on stimulus, we are probably going to be in surplus this year and next.

I would make a broader point. If you do not like this year's circumstance, then we really have two choices, which the President has clearly said what he thinks. You could raise taxes. The President thinks that is a terrible idea, that we would raise taxes right now, or you could reduce the spending the President has proposed for a variety of dozens or hundreds of programs that are in the Federal budget.

The President has gone systematically through all of the objects of expenditure and has recorded in writing his belief that the level of spending that he recommends is what is necessary to pursue the war on terrorism and to provide incremental, a total of $38 billion for homeland security and all of the other myriad of needs that we, as a people, believe we need to have.

And so I do not think there are too many choices. Either one can choose to say we should raise taxes in order to have a higher surplus, if you believe the economy would actually produce a higher surplus if we put more taxes on it or we can reduce spending. The President has made his judgment very clear.

Chairman CONRAD. And, look, the 1-year question, as I have made clear, is not the big problem I have got with what you have proposed or what the President has proposed. My problem is you have got 10 years, and you just made the reference again. You said without that stimulus, you would be close to surplus this year. You are not going to be anywhere close to surplus, not true surplus, because what you define as surplus is taking every penny of the Medicare Trust Fund money, every penny of the Social Security Trust Fund money and use it for other purposes, and you call it surplus. It is not surplus. It is money that is already fully committed, in fact, it is overcommitted.

And the use of surplus I think is the disservice to the American people because I think it fundamentally misleads them as to the financial condition of the country, and I think it is that use of language in there, and I am not just holding you out, that use of language that misleads people that is much of what happened at Enron. I believe this notion of not fully revealing debt to people leads them to conclusions that are mistaken, and I would just say to you I think this use of language is very important. Because I think when people hear there is surplus, they think, well, there is extra money here.

Chairman CONRAD.Senator Allard.

Senator ALLARD. Do we not have a provision in law that says that if there is any money that his left over in Social Security, it is goes to the general fund? So is it not incumbent upon the Congress to change that law? How can the President not abide by the law that the Congress is forcing on him? And then if you do that, and I have looked at that, see if you agree with me, there is a fiscal note that comes with that. So the only way you make up for that fiscal note is a huge tax increase. So my suggestion is——

Chairman CONRAD. No, no, no. That's——

Senator ALLARD [continuing]. Let us go ahead and change the law. And to correct the fiscal note, I would like to see you introduce a tax increase to meet the demands of that fiscal note.

Chairman CONRAD. Well, you introduce it. I am not proposing a tax increase——

Senator ALLARD. Well, I am not—we have a provision in law that says that the surplus——

Chairman CONRAD. We have a provision in law that you are not supposed to count the Social Security Trust Fund moneys as part of the deficit calculation, but nobody pays much attention to it, unfortunately. And this President has sent up a budget that assumes that over the next decade you are going to take a trillion and a half of Social Security dollars and use them for other purposes. He is going to take $500 billion of Medicare Trust Fund dollars and use those for other purposes.

Senator ALLARD. But the Congress, if you are going to expect that the President will put in a different package, a different budget, you have got to correct, Congress has to correct that one provision in there that says the surplus in Social Security has to go in the general fund. That is in law.

Chairman CONRAD. The law of the United States right now says that you are not supposed to calculate the deficit using Social Security surpluses, and we just had the Secretary of the Treasury describe this budget this year, without the stimulus package, as being in surplus, and the only way you can have that calculation is by taking every dime of the Social Security Trust Fund money. That is the Secretary of the Treasury describing that as surplus.

Senator ALLARD. Are you denying that we do not have a law in there that you should not transfer the dollars from Social Security to the general fund?

Chairman CONRAD. Look, the problem that we have is what we are doing is taking the money and using it for other purposes, and——

Senator ALLARD. And that law mandates that because it says you put it in the general fund.

Chairman CONRAD. Nothing required the President to send a budget to this Congress that took Social Security money and used it for other purposes. There is no law requiring him to do that whatsoever. And, in fact, last year he sent us a budget that did not. That is why the Secretary could last year tell us Social Security money was not going to be used for other purposes. Now every dime, not every dime for the whole 10 years, but 70 percent of it is going to be used in that way. That is where we have——

Secretary O'NEILL. Mr. Chairman, we could fix some of this confusion if we could have, for example, we could agree in modifying the way we do budgeting so that we had a cash account, and then we could get rid of this question.

Your question about Social Security I think is wholly appropriate, and I think all of us would agree we are going to have to do something about Social Security. I am one who believes the answer to Social Security is not eat your spinach and reduce benefits, it is use what we know about finance to create an even better future than what people can have with Social Security. So I do not think there is——

Chairman CONRAD. And there you and I may be closer to being on the same page than some others around this table, but that will be a debate, a discussion for another day.

I know we indicated we would try to end this at noon, and we told colleagues we would. We are a little past that, and I appreciate your patience.

Secretary O'NEILL. Thank you.

Chairman CONRAD. And I appreciate your participation here today.

Secretary O'NEILL. Thank you.

[Whereupon, at 12:13 p.m., the committee was adjourned.]

WRITTEN QUESTIONS TO SECRETARY O'NEILL AND THE RESPONSES

Question : The President's Budget proposes to use over $1.5 trillion of the Social Security surpluses over the next eleven years. How does the Administration plan to address the extraordinary financial burden that will hit when the baby boomers begin to retire en masse starting in 2008?

Answer: The Social Security Trust Fund continues to be credited with all Social Security payroll taxes as required by law. Despite recent events and the slowdown in the economy, the 2002 report on the status of the Social Security Trust Fund recently issued by the Social Security and Medicare Board of Trustees shows that income to the Trust Fund will exceed outlays until 2017, one year later than that shown in last year's report. The Trust Fund's projected exhaustion date has been extended from 2038 to 2041.

The welfare of future retirees and the economy are inextricably linked. Future retirees will enjoy substantial benefits from a stronger economy today. A stronger economy produces more tax revenue to help meet obligations to future retirees. A stronger economy also generates higher paying jobs, thereby allowing for a larger amount of resources to be saved for retirement. It also helps generate larger returns on the investments that millions of workers have made through 401(k) plans and other retirement plans. (The Administration's recent recommendations for reforming 401(k) plans will also help secure future retirement security.) Therefore, positive economic performance is a key ingredient to securing future retirement security.

However, unless action is taken in a timely manner, retirement benefits that must be paid to future retirees have the potential to significantly impact the government's fiscal position. The Administration believes that the best action is to begin pre-funding some of these future obligations today rather than waiting until the time of reckoning is upon us, which will require much larger steps. Personal retirement savings accounts are the best way to begin setting money aside today.

Question: Mr. Secretary, according to the National Conference of State Legislatures, forty-three States and the District of Columbia have reported that revenues were below forecasted levels in the opening months of FY 2002. Medicaid continues to exceed budgeted levels, proving to be an ongoing problem. At least 36 States have implemented or are considering budget cuts to address fiscal problems. Twenty-two States have implemented belt-tightening measures.

State fiscal conditions continue to deteriorate under the weight of growing needs and responsibilities. States are asking the Federal Government for additional funds to avoid painful tax increases and additional budget cuts. Yet the President's budget includes a number of proposals to cut Federal funds to States for transportation, crime prevention, unemployment assistance, job training, and health care services.

The fiscal health of the States is critical to the fiscal health of the national economy. How can this Administration work to improve the national economy while the State economies are weak and bleeding?

Answer: In bipartisan fashion, Congress recognized this concern with the recent adoption of the President's economic stimulus proposals to create and maintain jobs, and help put the economy back on a path of higher growth. Higher economic growth is the best way to address the fiscal situation of the States. The broader economic challenge, however, is to not become complacent about economic security; which includes renewed higher rates of economic growth, gains in productivity, or successes in the international marketplace.

Individuals and businesses make decisions based not only on today's information but also on expectations about the future. Prospects for lower tax rates in the future encourage individuals and businesses to undertake efforts today in anticipation of a higher after-tax rate of return in the future.

For example, businesses will make more investment now in order to attain higher production and income in the future when tax rates will be lower. In the absence of the lower expected tax rates, the expected after-tax rate of return would be lower and current investment would be lower than with expected declines.

Raising taxes by rescinding scheduled future tax cuts would further harm the prospects for higher economic growth. Individuals and businesses who are aware of the coming tax cuts and who are undertaking traditional investment and spending in expectation of higher future after-tax rates of return, would likely cut back on those plans and hurt current economic activity if the future tax rate reductions were eliminated.

Staying the course on reducing income tax rates is an important part of returning the economy to robust economic growth, and a growing economy is the most important factor in returning the budget to surplus both in Washington, DC and in the State capitals.

THE PRESIDENT'S FISCAL YEAR 2003 BUDGET REQUEST AND REVENUE PROPOSALS

TUESDAY, FEBRUARY 12, 2002

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, Byrd, and Gregg.

Staff present: Mary Ann Naylor, staff director; and Dakota Rudesill, analyst.

For the minority: G. William Hoagland; staff director and Bernadette Kilroy, senior analyst.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order. Welcome, Mr. Secretary. It is always a privilege to have you here before the committee.

As you know, Senator Domenici has been advised by doctors to take it easy for a bit, and so he will not be with us today. He has a statement for the record that we will make part of the record at this point.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Welcome once again to the committee Mr. Secretary.

Let me begin by thanking you Mr. Secretary and your team at the Department of State for the dedication, very hard work and commitment you all have brought to this war on terrorism.

I doubt any of us could have predicted—when you were before the committee a year ago—all the events that were to unfold in the world just a few months later.

I believe this Congress, indeed the Chairman has so indicated, will support the President's budget request for the war on terrorism. The most visible budget aspect of this support is the Defense spending request of nearly $400 billion.

Maybe the less visible—in budget terms for resources spent for this battle on terrorism is the internatonal affairs budget totaling slightly less than $24 billion—a small fraction of what we will allocate to the Department of Defense and about 1 percent of the total $2.1 trillion Federal budget request next year.

Even more stark in dollar terms is the fact that your Department—the State Department's total budget—totals less than $10 billion.

I see in this morning's news reports that a coalition of some 160 groups including Catholic Relief Service and CARE are describing your budget as "inadequate" and that the International Affairs budget request needs to be doubled.

I know that a number of Senators have written the President and you stating the need for more funding in this area.

Quite frankly, and being very honest, I do not know what the correct figure should be or if anyone can ever really know. I do not know what the correct balance is between using our superior military power to confront terrorism on the battle field versus what we should spend around a negotiating table to prevent future battles.

In the end the right number is probably not as important as finding the right policy that will help to support—and I use this word guardedly—help to build and promote Civil Societies and Democratic Institutions where they do not exist and where terrorism, and misinformation is allowed to spread hate and death.

You have I believe, along with the President, the most difficult job in the Cabinet. You have and will continue to receive advice from the Congress, from current and former foreign leaders, from general and ministers, journalists and academics throughout the world.

My input, Mr. Secretary is that in the end I believe we must maintain and build on our alliance that you have successfully recruited in this war on terrorism—including and particularly Russia.

I know our allies grumble about "unilateralism" and some fear we may "go it alone" with our military superiority in this battle. But I trust you Mr. Secretary and I know your counsel will be wise in these decision we are certain to confront.

Finally, Mr. Secretary, prior to the events of last September the President referred to our bilateral relationship with Mexico as the most important relationship in the world. I know that President Bush will be meeting with President Vicente Fox in a few weeks. Our neighbor to the south—Mexico has been a friend and fellow combatant in this war on terrorism. Let's keep that bilateral relationship strong.

Once again I thank you for your distinguished military service to the country in the past, and your continued service to the country today.

Chairman CONRAD. A number of our colleagues will be joining us. As you know, we are now all Enron all the time. And so I think there are maybe four or five hearings on Enron at different committees. We are not going to be talking about Enron here. We are going to be talking about the budget of the United States and how it relates to the 150 function and how it relates to the dramatic changes that we are confronting as a Nation since the attacks on this country on September 11th.

First of all, I want to say to you, Mr. Secretary, how much we respect how the President and his Administration have conducted themselves in the face of this attack. And certainly we want to acknowledge the extraordinary efforts that you have extended to manage this crisis. Our respect for you, which was always very high, has done nothing but grow as you have managed to hold the coalition together and have dealt, I think in a very thoughtful way, with the many demands on your time and on your energies in this period. So we thank you for that as Americans.

I have said from this podium many times that I have been proud as an American to see how we as a country have responded, and this hearing will be about other steps that are necessary and how they impact the budget. And I thought, just for setting the agenda, that I might go through what the President has proposed, what the priorities are that he has signaled to us, and then Senator Smith, who has been designated to fill in for Senator Domenici, is here and he will make his statement, and then we will hear from you. And then each of the members will have 7 minutes for their questioning and their comments. And if we have time for additional rounds, we will have them.

We have been advised there will be a vote at about 10:45, perhaps a series of votes at 10:45. So we will proceed with dispatch.

In the President's budget, this is what we see in terms of the percentage increases over the baseline. For those who are listening who aren't familiar with baseline, baseline takes previous budgets, adjusts them for inflation, adjusts them for increases in the number of people eligible for the various programs because of demographic changes.

This shows the increases in spending requests over that baseline, and as we can see, the President is asking for the biggest percentage increase over baseline in homeland security, 23 percent; a 10 percent increase over baseline for national defense; a 2 percent increase for international affairs; and all other domestic programs are being reduced 6 percent.

Let's go to the next chart which shows the billions of dollars over baseline, instead of looking in percentage terms, looking at the billions of dollars over baseline. We can see homeland security is $5 billion over the Congressional Budget Office baseline; national defense is $36 billion over the baseline; international affairs, $400 million; and all other domestic programs being reduced $23 billion.

Let's go to the next chart, international affairs priorities. Within the international affairs budget, this is what the President is recommending to us: Development and humanitarian assistance increased $114 million; international security, military assistance increased $417 million; all other activities reduced by $126 million.

Let's go to the next chart. There has been a lot of criticism of the United States for not being a big enough contributor to international affairs aid, and No. 1 in the world is Denmark. They are contributing just over 1 percent of their GNP for these purposes, for foreign aid contributions. They are the leader in the world, the biggest percentage of their GNP going for this purpose.

I am part Danish, and this summer my wife and I and my daughter went to the little village where my great-grandparents were married. And we had a chance while we were in Denmark to visit with them, and I tell you, this is a real source of pride in Denmark that they lead the world as a percentage of GNP in contributions to assisting other Nations.

We are one-tenth of 1 percent, so we are 22nd in the world, to put it perspective. On the other hand, let's put up that next chart. In dollar terms, we are No. 2. That is, we are 22nd in percentage of GNP going for foreign aid; on the other hand, we are No. 2 in the world in total dollars going for foreign aid. We are providing $9.6 billion a year. The Japanese outstrip us; they are at $13 billion. No. 3 is Germany at $5 billion.

So that gives a bit of an overview, putting things in perspective as we move forward and consider the question of what the budget should be in this area.

Mr. Secretary, when we get into the questions, there are going to be a number of things that I am going to inquire about. The President said in his State of the Union that we face an axis of evil of the North Koreans, the Iraqis, the Iranians. And so as we build a budget, we need to know what that means. What is it that we are going to confront? What is it that we need to consider as we write a budget?

Second, as I indicated to you, in the paper this morning I noticed that there are a number of foreign assistance groups that are asking for a doubling of aid, and we will want to talk a little about that, and other matters as well. But at this point, Senator Gregg, would you like to make an opening statement?

Senator GREGG. Actually, Mr. Chairman, I would like to hear from the Secretary, and so I will waive the opening statement and look forward to hearing the Secretary's comments.

Chairman CONRAD. All right. And we do have an opening statement from Senator Domenici, which I have indicated will be part of the record.

So, with that, Mr. Secretary, again, welcome. It is always good to have you here, and please proceed. Then we will have a chance for questions.

STATEMENT OF HON. COLIN L. POWELL, SECRETARY, UNITED STATES DEPARTMENT OF STATE

Secretary POWELL. Thank you very much, Mr. Chairman. It is a great pleasure to be before the committee again, and I thank you for your gracious words at the beginning of this hearing with respect to the manner in which President Bush and his Administration have handled the crisis that engulfed us on the 11th of September last, and I thank you for your personal comments with respect to me. But those comments are addressed really through me to the wonderful men and women of the State Department, who are doing such a great job at our missions and embassies and other facilities around the world. And I know that you travel, all of you travel from time to time, and I know that you share with me the admiration that we all have for the great job they do on the front line of "offense" of our national security efforts, as they like to say.

I am pleased, therefore, this morning to have the opportunity to testify in support of President Bush's budget request for the Department for Fiscal Year 2003. It is the support that you have given us in Fiscal Year 2002, and why I am here to defend the Fiscal Year 2003 budget, that keeps these men and women motivated, equipped, trained, prepared, and ready to do the job that the Nation asks of them. They go into harm's way every day just as much as any one of the men and women of our armed forces. They take risks and sometimes pay with their lives, or pay with injuries. As we saw in our newspaper this morning, the story of the gentleman who was seriously injured in the embassy bombing a few years ago, how he is coming back and how we have to do a better job of taking care of people such as that brave soldier of the State Department.

As many of you recall, in my first budget testimony to the committee last March—and I might digress for a moment, Mr. Chairman, to say that I do have a prepared statement which I offer for the record.

Chairman CONRAD. Without objection, that will be made part of the record.

Secretary POWELL. In my first budget testimony to the committee last March, I told you that the resource challenge for the Department of State had become a serious impediment to the conduct of United States foreign policy. I told you that it was a mystery to me how the great people at the State Department had continued to do their job, to do their work so very effectively over the past decade with such a low level of resourcing.

You heard my testimony and you responded, and we are grateful for that response. As a result, we got a 6 percent increase in the

International Affairs budget last year over the previous year, Fiscal Year 2001, and this year we are also asking for an increase.

Mr. Chairman, I wish that it was twice as much, three times as much, four times as much. But within the limits that we have placed upon us by the ability of the Nation to fund all of our many activities, and after competing within the Administration for our allocation of available funds, and recognizing the important needs that the Defense Department has and the new need that we have for homeland security, I am rather pleased that we are still able to get a real increase in our budget for this year as well.

I might also point out that even though the statistics you put up are quite correct, and the Danes can be very happy at being at the top of the pile—and we should be a little chagrined that only 0.1 percent of our gross national product goes to development assistance, at the same time the fact that we provide defense for the free world I think should also be taken into account. We spend more in defense than anyone else, and it is behind that screen of security that we provide for the civilized world that we are able to do the kinds of development activities that I talk about in my budget. And I think some consideration should be given to that, and, frankly, that is why the Defense Department was so deserving of a significant increase this year so that they can continue to perform that vital role for the free world.

With respect to State Department operations, our three principal priorities last year were people, information technology, and embassy construction and security. Let me update you on how we are doing in these areas as I go forward to talk about our priorities in this budget.

In new hires for the Foreign Service, we have made great strides. We have doubled the number of candidates for the Foreign Service written exam, and this year we will give the exam twice instead of just once. I am absolutely delighted with the turnout we are getting, youngsters showing up who want to serve their Nation as Foreign Service officers or in our civil service.

Our new recruits reflect better the diversity of our country with nearly 17 percent of those who passed last year's written exam being minority members. We have tripled the number of African Americans who have applied to the Foreign Service.

We have also improved civil service recruitment by creating new web-based recruiting tools and by vigorously asserting the truth. The truth, Mr. Chairman, is that we are a team at State and that the Foreign Service and the Civil Service are each important members of that team. And I am creating an environment down there of family and breaking down the barriers that might have existed in the past between what the Foreign Service and what the Civil Service does. We are all one Foreign Affairs team serving the Nation.

Another improvement is that once we identify the best people, we bring them on more quickly—a great boom to hiring the best. For Foreign Service recruits, for instance, we have reduced the time from written exam to entry into the service from 27 months, where we were last year, to less than a year. And I want to drive it down even further. We don't have time to wait to bring these wonderful youngsters in. They have other opportunities. We want them to see that they are in a fast-moving operation that wants quality people, and we are going to do everything we can to break down all of the walls and barriers that used to exist to accessing people into our service.

We are also working with the Office of Management and Budget to create extensive new performance measures to ensure that the people we hire remain the best throughout their careers. We want to make sure they are motivated, they are trained, they are given leadership training, they are given jobs that excite them so that it is a team they want to remain a part of for the rest of their career.

With respect to the next priority, information technology, we are well on the way to bringing state-of-the-art hardware and software to the entire Department. We have an aggressive deployment schedule for our unclassified system which will provide desktop internet access to over 30,000 State users worldwide.

We are deploying our classified connectivity program over the next 2 years. Our goal is to put the internet in the service of diplomacy, and we are well on our way to accomplishing that goal.

With respect to construction and security, we are right-sizing, shaping up, and bringing smarter management practices to our overseas buildings programs, as I told you we would last year.

The first change we made was to put retired General Chuck Williams in charge and give him Assistant Secretary equivalent rank. His Overseas Buildings Office has developed the Department's first master plan, which covers our major facility requirements through fiscal year 2007.

The Overseas Buildings Office is using best practices from industry, new embassy templates, and strong leadership to lower costs, increase quality, and decrease construction time.

As I told you last year, one of our goals was to reduce the average cost to build an embassy, and I believe we are well on our way to doing that.

And General Williams is making all of our facilities, overseas and stateside, more secure. By the end of Fiscal Year 2002, over two-thirds of our overseas posts should reach minimal security standards, meaning secure doors, windows, and perimeters.

We are also making progress in efforts to provide new facilities that are fully secure, with 13 major capital projects in design or construction, another eight expected to begin this fiscal year, and nine more in Fiscal Year 2003.

Mr. Chairman, all of these activities have improved morale at the State Department. Our people see things happening, things that enhance their quality of life, their security, their ability to do their jobs. Things like our interim childcare center at the National Foreign Affairs Training Center. It opened on September 4th and can handle a full complement of 30 infants and toddlers. Not something you would think a Secretary of State should worry about on a daily basis, but we do because it is important to the morale and welfare of the family members of the State Department team.

This idea of teamwork, this idea of family and the quality of life that must always nourish it, even in the remotest stations, is uppermost in our minds at the Department. While we concentrate on the Nation's foreign affairs, we must also focus on taking care of those Americans who conduct it, as well as the many thousands of Foreign Service Nationals who help us around the world.

The Foreign Service Nationals—not often spoken about—are an extraordinary group of people, Mr. Chairman. For example, our 60 Afghan employees in Kabul worked diligently to maintain and protect our facilities throughout the 13 years that the embassy was closed. They worked at personal risk. We made sure they were paid. They repaired the chancery roof when a rocket attack hit it. They did everything to make sure that they were ready for us when we returned.

In fact, I love to tell the story of going to the embassy a few weeks ago and congratulating them and thanking them, and having our charge there, Ryan Cocker, tell me that in the garage in the basement of the building, they maintained all of our vehicles so that after all those years, when we finally were able to open it up and those vehicles were brought out, all they needed was a charged battery, and they all started up. And the joke in the story is that if you want to see the finest fleet of 1985 Volkswagen Passats in the world, they are located at the American Embassy, Kabul, and waiting for your use when you have a chance to visit, Mr. Chairman.

But it is a team. It is the Foreign Service, Civil Service, Foreign Service Nationals all coming together. That is why for FY 2003 I will continue to drive these priorities, and I am going to be relentless as the CEO of the State Department as well as the Secretary of State worrying about foreign policy.

So let me speak first as the CEO.

The President's request for the Department of State and related agencies for FY 2003 is $8.1 billion. These dollars will allow us to continue to recruit, hire, train, and deploy the right work force. The budget request includes $100 million for the next steps in the hiring process that we began last year. With these dollars, we will be able to bring on board 399 more foreign affairs professionals and be well on our way to repairing the large gap that exists in our personnel structure.

We will also continue to upgrade and enhance our worldwide security readiness even more in light of our success in disrupting and damaging the al Qaeda terrorist network. The budget request includes $553 million that builds on the funding provided from the Emergency Response Fund for the increased hiring of security agents and for counterterrorism programs.

We will also continue to upgrade the security of our overseas facilities. The budget request includes over $1.3 billion to improve physical security, correct serious deficiencies that still exist, and provide for security-driven construction of new facilities at high-risk posts around the world.

I might, as an aside, mention especially for Senator Gregg that General Williams reported to me that the average cost of our embassies has been driven down some 20 percent as a result of the efforts he has made and the work of his office over the past year.

Next, we will continue our program to provide state-of-the-art information technology to our people everywhere, as I mentioned earlier, and we have included $177 million for that purpose.

We want to continue to enhance our Educational and Cultural Exchange Programs. The budget request includes $247 million for strategic activities that build mutual understanding and develop friendly relations between America and the peoples of the world. Such activities have gained a new sense of urgency and importance since the brutal attacks of September. We need to teach the world more about America, about our value system and what we believe in. President Bush in his State of the Union address, at the very tail end of the address, talked about values—values that are not just American values, but values that we believe are universal. And in order to share these values with the rest of the world, we have to do a better job with our Educational and Cultural Exchange Programs.

We want to continue to meet our obligations to international organizations, which are also important in our war on terrorism. The budget request includes $890 million to fund United States assessments to 43 international organizations, active membership of which furthers United States economic, political, security, social, and cultural interests.

We want to continue to try to meet our obligation to international peacekeeping operations. The budget request includes $726 million to pay our projected United Nations peacekeeping assessments—all the more important as we seek to avoid increasing even further our U.N. arrearages. And, Mr. Chairman, I ask for your help in getting the cap lifted so that we can eventually eliminate all of the arrearages.

We want to also strengthen and enhance our public diplomacy effort. This goes along with our cultural exchange program, but we have got to do a better job in public diplomacy to eliminate support for terrorists and to deny them safe haven in countries where they are still received as some sort of false hero. The budget includes almost $518 million for international broadcasting, of which $60 million is for the war on terrorism. This funding will enable the Voice of America and Radio Free Europe/Radio Liberty to continue increased media broadcasts to Afghanistan and the surrounding countries and throughout the Middle East. These international broadcasts help inform local public opinion about the true nature of al Qaeda and the purposes of the war on terrorism, helping to build support for the coalition's global campaign.

Mr. Chairman, let me just touch a little bit more on our public diplomacy efforts. The terrorist attacks of September 11th underscored the urgency of implementing an effective public diplomacy campaign. Those who abet terror by spreading distortion and hate and inciting others take full advantage of the global news cycle. We have to do the same thing.

Since September 11th, there have been over 2,000 media appearances by State Department officials. Our continuous presence in Arabic and regional media by officials with language and media skills has been unprecedented. Our international information website on terror is now online in seven languages. Internet search engines show it is the hottest page on the topic. Our 25-page color publication, "The Network of Terrorism," is now available in 30 languages with many different adaptations, including a full insert in the Arabic edition of Newsweek. When the President gave his

State of the Union speech, we had it simultaneously translated as he was speaking and downloaded on to on all of our websites and other media outlets throughout the world. And within an hour and a half after he was finished, we had a translated hard copy into seven different languages and had it downloaded all over the world. "Right content, right format, right audience, right now" describes our strategic aim in seeing that United States policies are explained and placed in the proper context in the minds of foreign audiences.

Mr. Chairman, all of the State Department and related agencies programs and initiatives that I have touched on and so many others that are in the budget are critical to the conduct of America's foreign policy. And so as the State Department CEO, let me thank you again for what you have done to help us create such a first-class offense. And I want to ask you to continue your excellent support so we can finish the job by bringing the Department of State and the conduct of America's foreign policy into the 21st century.

Now let me turn, Mr. Chairman, to the budget request for foreign operations.

Over the past year, Mr. Chairman, I believe the broader tapestry of our foreign policy has become clear, to encourage the spread of democracy and market economies and to bring more nations to the understanding that the power of the individual is the power that counts, and when evil appears to threaten this progress, America will confront the evil and defeat it, as we are doing in the war on terrorism.

In weaving this tapestry, we have achieved several successes in addition to the successes of the war on terrorism and the regional development that skillful pursuit has made possible.

We talk about terrorism all the time, but we shouldn't overlook how much we have improved our relations with Russia, set a new and smoother course with China, the two major accounts that we really have to focus on, Russia, that land still of 11 time zones, nuclear-armed, but it has left the Soviet Union days behind. It wants to come West. It wants to be part of NATO, Russia at 20. It wants to integrate itself into the economies of the west. It still wants to have good neighborly relations with China, and it still worries about the Nations to its south, but it knows its future lies to the west. And it is cooperating with us in ways that we might not have imagined just a year ago, cooperating with us on the campaign against terrorism.

We are able to move United States troops throughout Central Asia by telling the Russians that we are there to defeat a common enemy, terrorism, fundamentalism, not to threaten Russia's southern flank.

I am able to talk to my Russian counterpart three, four, five times a week. We no longer even ask for talking points from our staff. My staff knows what I do now. I just call out to the front office, "Get Igor on the phone," and within a few minutes, Igor is on the phone, Foreign Minister Ivanoff, and we talk. And he doesn't delay the phone call waiting for his talking points from the staff. We know what is on each others mind. We know what our two presidents want us to do to make this a stronger, better relationship.

President Putin and President Bush have the same kind of relationship, and you saw it pay off when we faced the challenge of the ABM Treaty last fall. They disagreed. They thought we made a mistake by saying that we were going to leave the ABM Treaty. We thought they were wrong. We exchanged those views. At the end of the day, we agreed to disagree, and as President Putin said to me when I was explaining to him the President's decision and how we were going to implement it and choreographing with him what we would say, what they would say, he said, "Fine. We disagree, but our strategic relationship is far more important than this disagreement, and now this disagreement is behind us. Let's move forward, and let's move forward to cut those strategic offensive forces that really threaten to kill people. And we will discuss more defenses which protect people."

So we have a strong relationship with Russia, and we are trying to develop a similar one with China, and we have had considerable success. People thought we were in trouble last April when we had the incident with the reconnaissance plane that the Chinese ran into and our plane landed at Hainan Island, but we got through that in a couple weeks time, and got our plane back.

I had a successful trip last summer after this incident took place, and then the President had a very successful trip when he went to Shanghai for the APEC Summit. And he is looking forward to another successful meeting with President Chen Shui-bian next week when we go to China again.

The same applies to our relationship with Japan and Korea and our other friends in the region. They are all solid, and they are all growing. The President is very much looking forward to visiting South Korea to show that the bond between us and the South Koreans is as strong as ever. He will talk about North Korea. He will talk about the hope he has for North Korea, that some day the North Korean people will enjoy the kind of life that South Koreans have. His hope is that one day, a way will be found for these two Nations to, once again, be one people.

They have been one people for most of their recorded history, and he will show his support for the policies of the South that are encouraging the North to come out of its isolation, but, at the same time, we will not shrink from pointing out the nature of the North Korean regime. It is a regime that does not benefit its own people. They develop weapons, weapons that they sell to other nations that are not interested in helping their own people.

So the President has clearly identified the nature of this regime, but, at the same time, he has also said to the North Koreans, as he has said to the South Koreans, we are ready to talk to the North Koreans, we are ready for dialog anytime, anyplace, anywhere, with no preconditions.

I repeat that again this morning, as the President will next week in Korea, and we hope that the North Koreans will take us up on it. We want dialog, but, at the same time, we will not deny the obvious truth as to the nature of that regime, and we will not step back from talking about programs that they have and things that they are doing which are not in the interest of the civilized world.

So I think we have demonstrated that we are anxious to reach out to the world. We are not unilateralists pulling back. The President is going to Asia. The President has been to Europe several times. There is a steady stream of visitors in to see the President.

Look at my calendar any week you wish to, Mr. Chairman, and you will see how many foreign leaders that I meet with, but where there is a matter of principle, where we believe strongly about something and we have to stick by our principles, we will do that and lead and try to convince others to go with us. This isn't unilateralism. This is leadership, and our friends, I think, are increasingly coming to the understanding that this is principled leadership, the kind that they should respect, follow where they think it is appropriate to follow, and where they think it is not appropriate to follow, let them make their own individual sovereign choice.

But we are committed to the great alliances of which we are a part, and nowhere is that more the case than in Europe where the President is looking for the opportunity to expand NATO at the Prague Summit later this year, where he is anxious to read Russia into NATO, Russia at 20, hopefully by the Reykjavik Ministerial meeting this spring or in Prague this fall.

We are active with our partners in the European Union to improve economic conditions for all the nations of Europe, and you can see that through the President's free trade agenda, we are anxious to reduce trade barriers so that nations around the world cannot just sit around waiting for aid, but can trade. Trade is better than aid, and they can all start moving up out of the poverty that afflict so many nations of the world.

The President has the same view with respect to our own interest here in the Western Hemisphere. His agenda includes a Free Trade Area of the Americas. It includes passing Andean Trade Preferences Act again, so that we can help our friends in the Andean region. He wants a United States/Central America free trade agreement. He is going to the conference in Monterey next month on development assistance. We are engaged everywhere throughout the world, and I would be remiss if I didn't talk about Africa because it is an area that the President is also deeply interested in.

The African Growth and Opportunity Act, we want to see that enhanced. We had the first forum on that act here in the United States last fall, right after September 11th. It was the first international meeting we had, right after September 11th, and that was to bring over 30 African leaders to the United States to talk about trade.

He is looking forward to sending a strong delegation to the World Summit on Sustainable Development in Johannesburg, and demonstrating to Africa, the northern part of Africa, especially Sub-Saharan Africa, our interest in the continent, and nowhere, I think, is that more obvious in what we are doing with HIV/AIDS; over the last year alone, we have provided $500 million for the global trust fund, in addition to many, many hundreds of additional million dollars on internal HIV/AIDS programs and other bilateral assistance that we provide to countries that are fighting this scourge.

Mr. Chairman, all of these items and areas that I have touched on take money, and I think you will find in our budget a reasonable balance in light of the fiscal circumstances that the country finds itself in. And I am pleased that we were able to get real growth in our budget this year, and a number of our accounts have been able to go up. Some accounts have gone down, but, for the most part, I think we can make a case for why those accounts have gone down.

So I am optimistic about the world that is ahead of us. We have a coalition fighting terrorism with the major countries of the world. We have good relations, but there are still some very troubling areas.

The Middle East is a problem that dominates part of my day, every day, as we work hard to get a cease-fire in place to implement the Mitchell Peace Plan.

The President remains engaged. He met with Prime Minister Sharon last week. We are in contact with Chairman Arafat and his closest associates to try to get more movement with respect to the arrest of terrorists and with respect to accounting for the Karin A, that ship that had the arms aboard, and Chairman Arafat wrote me a somewhat positive letter on this subject 2 days ago, a letter which we are now examining.

The President will not rest until we get a cease-fire and get negotiations started. We still have as the American vision two states living side by side in that troubled land, one, a Jewish state called Israel, the other, a Palestinian state called Palestine.

We still have a problem with nations such as Iran and Iraq. The President did not shrink from describing the nature of those regimes as he talked about the axis of evil. I don't think I need to spend a lot of time on Iraq. We continue to develop sanctions and improve our sanctions regime toward Iraq to make sure that they do not succeed in their horrible quest to develop weapons of mass destruction. We also are examining options with respect to regime change because the people of the region, the people of the world, and the people of Iraq will be better off with a new regime.

With respect to Iran, we have offered Iranians dialog. We do have ways of speaking to them, even though we don't have diplomatic relations with them. We are in touch with them. We do talk to them. I have taken note of the fact that they have played a helpful role in the Bonn Conference that set up the interim authority in Afghanistan. They played a helpful role in the Japanese reconstruction conference, and I thanked them for that helpful role, but, at the same time, we see the Iranians doing other things in Afghanistan that are troubling. And we are going to call them to account for these things, whether it is trying to gain undue influence or introduce arms into Western Afghanistan, or their attitudes toward the Karzai government.

We have to take note of the fact that Iran continues to develop weapons of mass destruction and the means to deliver them, and by not shrinking from this reality, but calling this reality exactly what it is, I don't think this is a way of threatening the people of Iran. We want the best for the people of Iran, but at the same time, we must not shrink from the nature of the leadership, the unelected leadership of this country, and we should hope that the elected leadership of this country, which I believe holds views that are more beneficial to the people of Iran, will, in due course, see that their views prevail.

I know you touched on the axis of evil earlier, Mr. Chairman. I wanted to end my prepared testimony by responding in kind by saying that I think that this is a clear-headed, realistic policy, even though it has caused some distress here and there. I think it is understood by most people, and I think most people understand the President is not looking for a war.

We are looking for peace, but you don't find peace by sticking your head in the sand and ignoring evil where it exists, and I think President Bush has shown leadership in pointing it out so clearly in the actions we have taken previously, the policies that we are following, to see if dialog is possible, to see if peaceful solutions are possible, but, at the same time, not ignore our ultimate responsibilities if diplomacy and political action is not successful.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Powell follows:]

THE PREPARED STATEMENT OF COLIN L. POWELL, SECRETARY UNITED STATES DEPARTMENT OF STATE

Mr. Chairman, members of the committee, I am pleased to appear before you to testify in support of President Bush's budget request for fiscal year 2003.

Let me say at the outset, Mr. Chairman, before I go into the specifics of the budget request, that President Bush has two overriding objectives that our foreign policy must serve before all else. These two objectives are to win the war on terrorism and to protect Americans at home and abroad. This Administration will not be deterred from accomplishing these objectives. I have no doubt that this committee and the Congress feel the same way. As you will see when I address the details of the budget request, a significant part is related to accomplishing these two objectives.

As many of you will recall, at my first budget testimony to this committee last March I told you that the resources challenge for the Department of State had become a serious impediment to the conduct of the Nation's foreign policy. I told you that it was a mystery to me how the great people at the State Department had continued to do their work over the past decade with so little resources.

And you heard my testimony and you responded, and we are grateful.

Because of your understanding and generosity, we have made significant progress. We will make even more in what remains of fiscal year 2002.

With respect to State Department operations, our three principal priorities last year were people, information technology, and embassy construction and security. Let me update you on how we are doing in these areas.

In new hires for the Foreign Service, we have made great strides. We doubled the number of candidates for the Foreign Service Written Examination—and this year we will give the exam twice instead of just once. Moreover, our new recruits better reflect the diversity of our country with nearly 17 percent of those who passed last September's written exam being members of minority groups. For example, we tripled the number of African-Americans.

We have also improved Civil Service recruitment by creating new web-based recruiting tools and by vigorously asserting the truth. The truth, Mr. Chairman, that we are a team at State and that the Foreign Service and the Civil Service are each very important team members. No difference. Both are vital to our mission. And now both know it.

Another improvement is that once we identify the best people we bring them on more quickly—a great boon to hiring the best. For Foreign Service recruits, for instance, we have reduced the time from written exam to entry into service from 27 months to less than a year. We are going to reduce it even further.

We are also working with OMB to create extensive new performance measures to ensure that the people we hire remain the best throughout their careers.

With respect to information technology, we are well on the way to bringing state-of-the-art hardware and software to the entire Department. We have an aggressive deployment schedule for our unclassified system which will provide desktop Internet access to over 30,000 State users worldwide.

And we are deploying our classified connectivity program over the next two years. Our goal is to put the Internet in the service of diplomacy and we are well on the way to accomplishing it.

With respect to construction and security, we are right-sizing, shaping up and bringing smarter management practices to our overseas buildings program, as I told you we would do last year.

The first change we made was to put retired General Chuck Williams in charge and give him assistant secretary equivalent rank. Now, his Overseas Building Operations (OBO) has developed the Department's first master plan, which covers our major facility requirements through Fiscal Year 2007.

The OBO is using best practices from industry, new embassy templates, and strong leadership to lower costs, increase quality, and decrease construction time.

As I told you last year, one of our goals is to reduce the average cost to build an embassy. I believe we are well on the way to doing that.

And General Williams is making all of our facilities, overseas and stateside, more secure. By the end of fiscal year 2002, over two-thirds of our overseas posts should reach minimal security standards, meaning secure doors, windows, and perimeters.

We are also making progress in efforts to provide new facilities that are fully secure, with 13 major capital projects in design or construction, another eight expected to begin this fiscal year, and nine more in fiscal year 2003.

Mr. Chairman, all of these activities have improved morale at the State Department. Our people see things happening, things that enhance their quality of life, their security, their ability to do their jobs. Things like our interim childcare center at the National Foreign Affairs Training Center. It opened on September 4 and can handle a full complement of 30 infants and toddlers.

This idea of teamwork, this idea of family and the quality of life that must always nourish it even in the remotest station, is uppermost in our minds at the Department. While we concentrate on the Nation's foreign affairs we must also focus on taking care of those Americans who conduct it, as well as the many thousands of Foreign Service Nationals who help us across the globe.

These are an extraordinary group of people, Mr. Chairman. For example, our sixty Afghan employees in Kabul worked diligently to maintain and protect our facilities throughout the 13 years the Embassy was closed. They worked at considerable personal risk and often went months without getting paid. They even repaired the chancery roof when it was damaged by a rocket attack. This is the sort of diligence and loyalty that is typical of our outstanding Foreign Service Nationals.

Our whole team at State is vital to mission accomplishment—Foreign Service, Civil Service, and Foreign Service Nationals. The dollars you helped to provide us last year allowed us to make our team more cohesive and more effective. We want to continue that process.

That is why for fiscal year 2003 you will get no break from me. I am going to be as relentless as CEO of the State Department as I am as principal foreign policy advisor to the President.

So let me speak as CEO first.

The Budget Priorities for Fiscal Year 2003: Department of State and Related Agencies

The President's request for the Department of State and Related Agencies for fiscal year 2003 is $8.1 billion. These dollars will allow us to:

- Continue initiatives to recruit, hire, train, and deploy the right work force. The budget request includes $100 million for the next step in the hiring process we began last year. With these dollars, we will be able to bring on board 399 more foreign affairs professionals and be well on our way to repairing the large gap created in our personnel structure and, thus, the strain put on our people by almost a decade of too few hires, an inability to train properly, and hundreds of unfilled positions. In fiscal year 2004, if we are able to hire the final 399 personnel, we will have completed our three-year effort with respect to overseas staffing—to include establishing the training pool I described to you last year that is so important if we are to allow our people to complete the training we feel is needed for them to do their jobs. Next February, I will be back up here briefing you on the results of our domestic staffing review.
- Continue to upgrade and enhance our worldwide security readiness—even more important in light of our success in disrupting and damaging the al-Qaida terrorist network. The budget request includes $553 million that builds on the funding provided from the Emergency Response Fund for the increased hiring of security agents and for counterterrorism programs.
- Continue to upgrade the security of our overseas facilities. The budget request includes over $1.3 billion to improve physical security, correct serious deficiencies that still exist, and provide for security-driven construction of new facilities at high-risk posts around the world.

- Continue our program to provide state-of-the-art information technology to our people everywhere. Just as I promised you last year, the budget request will continue projects aimed at extending classified connectivity to every post that requires it and to expanding desktop access to the Internet for Department employees. We have included $177 million for this purpose. Over the past decade, we let the Department's essential connectivity ebb to very low levels and we need to correct that situation.
- Continue and enhance our educational and cultural exchange programs. The budget request includes $247 million for strategic activities that build mutual understanding and develop friendly relations between America and the peoples of the world. These activities help build the trust, confidence, and international cooperation necessary to sustain and advance the full range of our interests. Such activities have gained a new sense of urgency and importance since the brutal attacks of September. We need to teach more about America to the world. We need to show people who we are and what we stand for, and these programs do just that.
- Continue to meet our obligations to international organizations—also important as we pursue the war on terrorism to its end. The budget request includes $891.4 million to fund United States assessments to 43 international organizations, active membership of which furthers United States economic, political, security, social, and cultural interests.
- Continue to try to meet our obligations to international peacekeeping activities. The budget request includes $726 million to pay our projected United Nations peacekeeping assessments—all the more important as we seek to avoid increasing even further our UN arrearages. And, Mr. Chairman, I ask for your help in getting the cap lifted so that we can eventually eliminate all our arrearages. These peacekeeping activities allow us to leverage our political, military, and financial assets through the authority of the United Nations Security Council and the participation of other countries in providing funds and peacekeepers for conflicts worldwide.
- Continue and also enhance an aggressive public diplomacy effort to eliminate support for terrorists and thus deny them safe haven. The budget includes almost $518 million for International Broadcasting, of which $60 million is for the war on terrorism. This funding will enable the Voice of America and Radio Free Europe/Radio Liberty to continue increased media broadcasts to Afghanistan and the surrounding countries and throughout the Middle East. These international broadcasts help inform local public opinion about the true nature of al-Qaida and the purposes of the war on terrorism, building support for the coalition's global campaign.

Mr. Chairman, on this last subject let me expand my remarks.

The terrorist attacks of September 11 underscored the urgency of implementing an effective public diplomacy campaign. Those who abet terror by spreading distortion and hate and inciting others, take full advantage of the global news cycle. We must do the same. Since September 11, there have been over 2,000 media appearances by State Department officials. Our continuous presence in Arabic and regional media by officials with language and media skills, has been unprecedented. Our international information website on terror is now online in seven languages. Internet search engines show it is the hottest page on the topic. Our 25-page color publication, "The Network of Terrorism", is now available in 30 languages with many different adaptations, including a full insert in the Arabic edition of *Newsweek*. "Right content, right format, right audience, right now" describes our strategic aim in seeing that United States policies are explained and placed in the proper context in the minds of foreign audiences.

I also serve, ex officio, as a member of the Broadcasting Board of Governors, the agency that oversees the efforts of Voice of America and Radio Free Europe/Radio Liberty to broadcast our message into South Central Asia and the Middle East. With the support of the Congress, our broadcasting has increased dramatically since September 11. We have almost doubled the number of broadcast hours to areas that have been the breeding grounds of terrorists. The dollars we have requested for international broadcasting will help sustain these key efforts through the next fiscal year.

Mr. Chairman, all of these State Department and Related Agencies programs and initiatives are critical to the conduct of America's foreign policy. Some of you know my feelings about the importance to the success of any enterprise of having the right people in the right places. If I had to put one of these priorities at the pinnacle of our efforts, it would be our hiring efforts.

We must sustain the strong recruiting program we began last year. We want to get to a point where our people can undergo training without seriously jeopardizing their missions or offices; where our men and women don't have to fill two or three positions at once; and where people have a chance to breathe occasionally.

Out on the front lines of diplomacy, we want a first-class offense for America. As a soldier, I can tell you that quality people with high morale, combined with superb training and adequate resources, are the key to a first-class offense.

So as the State Department's CEO, let me thank you again for what you have done to help us create such a first-class—offense and I want to ask you to continue your excellent support so we can finish the job of bringing the Department of State and the conduct of America's foreign policy into the 21st century.

Now, let me turn to the budget request for foreign operations.

Foreign Policy: Successes, Challenges, and Opportunities

Over the past year, Mr. Chairman, I believe the broader tapestry of our foreign policy has become clear: to encourage the spread of democracy and market economies and to bring more Nations to the understanding that the power of the individual is the power that counts. And when evil appears to threaten this progress, America will confront that evil and defeat it—as we are doing in the war on terrorism.

In weaving this tapestry, we have achieved several successes in addition to the successes of the war on terrorism and the regional developments its skillful pursuit has made possible.

We have improved our relations with Russia, set a new and smoother course with China, reinvigorated our Asia and Pacific alliances, and worked successfully with our European partners to ensure continued stability in the Balkans. Moreover, we reduced the level of concern in Europe over what some there thought was a United States go-it-alone policy, notwithstanding some recent comments from Europe with regard to President Bush's State of the Union address.

Further, we have broadened our cooperation with Central Asia, and set a more effective policy in place for Africa based on good governance, reinvigoration of agriculture, and integration into the globalized world of trade and commerce. Plus, we are attacking HIV/AIDS in Africa and elsewhere with bilateral as well as international efforts.

Add to these successes our constructive focus on our own hemisphere, from Canada to the Caribbean, from Mexico to South America, and you have a solid record of achievement.

There are some dark clouds of course—in the Middle East, in South America, and in South Asia. But we are working these issues. There is effective policy in place and good people are pushing the policy.

All of these efforts require resources. So let me turn to the specifics of our budget request for foreign operations.

The Budget Priorities for Fiscal Year 2003: Foreign Operations

The President's fiscal year 2003 request for Foreign Operations is a little over $16.1 billion. These dollars will support the continuing war on terrorism, the work we are doing in Colombia and the Andean region at large, our efforts to combat HIV/AIDS and other infectious diseases, essential development programs in Africa, the important work of the Peace Corps and the scaling up of that work, and our plan to clear arrearages at the Multilateral Development Banks, including the Global Environment Facility.

War on Terrosim

To fight terrorism as well as alleviate the conditions that fuel violent extremism, we are requesting an estimated $5 billion. In addition to the initiatives outlined previously under the budget for the State Department and Related Agencies, this funding includes:

- Foreign assistance—$3.6 billion for economic and security assistance, military equipment, and training for front-line states and our other partners in the war on terrorism. This amount includes:
- $3.4 billion from Foreign Operations accounts such as the Economic Support Fund, International Military Education and Training, Foreign Military Financing, and Freedom Support Act.
- $88 million for programs in Russia and other states of the former Soviet Union to reduce the availability to terrorists of weapons of mass destruction. Ongoing programs engage former weapons scientists in peaceful research and help prevent the spread of the materials expertise required to build such weapons.
- $69 million for counterterrorism engagement programs, training, and equipment to help other countries fight global terror, thereby strengthening our own national security.

- $4 million for the Treasury Department's Office of Technical Assistance to provide training and other necessary expertise to foreign finance offices to halt terrorist financing.

And Mr. Chairman, in the fiscal year 2003 budget request there is approximately $140 million available for Afghanistan, including repatriation of refugees, food aid, demining, and transition assistance. I know that President Bush, the Congress, and the American people recognize that re-building that war-torn country will require additional resources and that our support must be and will be a multi-year effort. Moreover, we do not plan to support reconstruction alone and we will seek to ensure that other international donors continue to do their fair share.

To meet our commitment to assist Afghanistan in its reconstruction efforts, we will need a supplemental appropriation this year. Also, there are other areas associated with the war on terrorism where we may need supplemental funding this year. Right now we are working the details with OMB.

Andean Counter-drug Initiative

We are requesting $731 million in fiscal year 2003 for the multi-year counter-drug initiative in Colombia and other Andean countries that are the source of the cocaine sold on America's streets. ACT assistance to Andean governments will support drug eradication, interdiction, economic development, and development of government institutions, in addition, the Colombians will be able to stand up a second counterdrug brigade. Assisting efforts to destroy local coca crops arid processing labs there increases the effectiveness of United States law enforcement here.

In addition to this counterdrug effort, we are requesting $98 million in FMF to help the Colombian Government protect the vital Cano Limon–Covenas oil pipeline, which in 2001 was attacked 166 times by FARC and ELN guerrillas, costing Colombia revenue, causing serious environmental damage, and depriving us of a source of petroleum. This money will help train and equip two brigades of the Colombian armed forces to protect the pipeline.

Global Health and HIV/AIDS

In fiscal year 2003, we are requesting $1.4 billion for USAID global health programs. Of this amount, we are requesting $540 million for bilateral HIV/AIDS prevention, care, and treatment activities, and $100 million for the Global Fund to Fight AIDS, Tuberculosis, and Malaria. All of this funding will increase the already significant United States contribution to combating the AIDS pandemic and make us the single largest bilateral donor to the effort. I should add that the overall United States Government request for international HIV/AIDS programs exceeds one billion dollars, including $200 million for the Global Fund.

The Peace Corps

All of you heard the President's remarks in his State of the Union address with respect to the USA Freedom Corps and his objective to renew the promise of the Peace Corps and to double the number of volunteers in the Corps in the next five years. We have put $320 million for the Peace Corps in the fiscal year 2003 budget request. This is an increase of over $42 million over our fiscal year 2002 level. This increase will allow us to begin the scaling up that the President has directed. The Peace Corps will open programs in eight countries, including the restablishment of currently suspended posts, and place over 1,200 additional volunteers worldwide. By the end of fiscal year 2003 the Peace Corps will have more than 8,000 volunteers on the ground.

MDB Arrears

The fiscal year 2003 request includes an initiative to pay one third of the amount the United States owes the Multilateral Development Banks (MDBs) for our scheduled annual commitments. With United States arrears currently now totaling $533 million, the request would provide $178 million to pay one third of our total arrears during the fiscal year. The banks lend to and invest in developing economies, promoting economic growth and poverty reduction and providing environmental benefits. We need to support them.

Summing Up

Mr. Chairman, you have heard from me as CEO of the State Department and as principal foreign policy advisor to the President. I hold both responsibilities dear. Taking care of the great men and women who carry out America's foreign policy is as vital a mission in my view as helping to construct and shape that foreign policy.

As I told this committee last year and as I have already reminded it again this year, the conduct of the Nation's foreign policy suffered significantly from a lack of resources over the past decade. I have set both my CEO hat and my foreign policy hat to correct that situation. But I cannot do it without your help and the help of your colleagues in the Senate and across the Capitol in the House. I believe we have demonstrated in the past year that we are worth the money. I believe we have demonstrated that we can be wise stewards of the people's money and put it to good use in the pursuit of America's interests abroad. I also believe that we have demonstrated conclusively that we are essential to that process of pursuing the Nation's interests. With your able assistance, we will continue to do so in the months ahead.

Thank you, and I will be pleased to address your questions.

Chairman CONRAD. Thank you, Mr. Secretary.

As always, you have done just an excellent job of making the case, and we appreciate that.

Let me say to you that the problem that we face as the Budget Committee and the problem that the Congress faces can perhaps be best summed up by this chart.

Last year, when increases were provided, we had a forecast of surpluses, very substantial non-trust fund surpluses for the next decade. Now we see a complete reversal, and all we see is non-trust fund deficits for the next decade.

So, when increases are asked for by any agency, all of that increase will be coming out of Social Security Trust Fund moneys, and so the question that we have to answer is what are the priorities. The American people have told us very clearly they don't want Social Security Trust Fund money used for other purposes, however meritorious. They don't want that.

If we believe that, and I do, I think it is a serious mistake to use trust fund moneys when the baby-boomers start to retire in 6 years, and we all know where we are headed in terms of the demands on the fiscal resources of the Federal Government. The question comes when you ask for an increase, and you have done a superb job of justifying that request. I told staff here, I think you are the best witness that has ever come before this Committee, but with that said, it still leaves us with this fundamental question: where does the money come from.

Do you believe that the priorities that you are asking for are sufficiently important that if we are not to take it out of Social Security, that we should either cut spending other places or raise the revenue to pay for it? So I would ask you, are these requests that you have made of sufficient importance that if this committee and the broader Congress determined we are not going to use Social Security money to pay for these increases, that we would have to cut spending elsewhere or raise revenue elsewhere? Would you support that?

Secretary POWELL. I think the request that I had made to you, that the President has made to you for my accounts, is reasonable. It is quite modest. I think it was decided at this level consistent with the needs of the other Departments, and so I support the President's priorities. And I could not identify somewhere else within the Administration's budget that it should be taken from. Everybody has made their case, and the President made the allocation he did.

I think we are in a period of deficit spending, and I hope that as we prevail in this campaign against terrorism, as we build our defense, those kinds of claims against the budget will be reduced in future years. And I hope that the economy returns to a position of strong growth, which will also help eliminate the deficit, but right now I cannot give you an answer, since the President is not asking for increases in revenues. He is not asking for an increase in taxes, and, therefore, I don't have an answer for you as to where the source of the funding should come, except within the $2.1-trillion amount that the President has asked for, for FY 2003.

I think that the $25 billion-plus asked for by the Department of State is a reasonable investment in the foreign affairs activities of the United States Government.

Chairman CONRAD. Let me just say I understand your answer, but I have got to tell you, it does not solve the problem, and the problem is very fundamental. This is an ocean of red ink, and it is not just this year, not next year. It is the entire next decade, taking nearly $2 trillion out of the Social Security Trust Fund to pay for these other things, taking $500 billion from the Medicare Trust Fund to pay for these other things. Some of us just don't think that is appropriate. It is a profound mistake for the economic future and fiscal future of the country.

So, if we are going to reduce those invasions of the trust funds, where does the money come from? You have come here. You have made a very powerful case, as you always do. The question is: Where does the money come from? That is the question we have got to answer, and so I am asking for your help.

If these priorities are critically important, as you describe, do we cut spending other places? If we don't do that, do we raise revenue to pay the bill? And your answer is?

Secretary POWELL. Or, do you increase the national debt? And I think where we are right now is that for the next several years, we may well have to increase the debt, as your chart shows, in order to deal with these priorities.

I have restrained my appetite in presenting my case to OMB and to the President. I would like to have asked for a lot more. To some extent, I cut from what my staff thought was appropriate and what I thought was appropriate because I knew that there were limits to what the President could do. So I believe that my budget is a reasonable one. It shows some real growth, and it recognizes that a lot more growth is needed for homeland security and for the Defense Department.

The President made a judgment that this combination of spending, which focused on homeland security, focused on defense, focused to a slight extent on foreign operations and the running of the State Department, cut other Departments, and also picked up additional debt for the American people, was the right allocation and the right way to go about it in the hope that economic growth would return quickly and it would cause there to be less debt on the American people as a result of the necessary expenditures.

Your chart also showed that for the last 10 years and for many years before that, we were also running a deficit. We were fortunate to come out of that for a year or so, and now we are back down into a deficit-spending situation. I hope that we will see that black little hilltop you show return with the restoration of economic growth.

To some extent, it was the terrorist incidents of last year which hurt the economy and probably kicked it into the situation we have now.

Chairman CONRAD. Let me just say to you, Mr. Secretary, that in these numbers, there is forecast of strong economic growth. The Administration is forecasting a 3.1-percent economic growth on average for the 10 years, and, yet, still we see massive deficits, and not just for the year or two, not just the time of economic downturn, but through the entire decade.

As I indicated, $2.2 trillion under the President's plan is being taken for Medicare and Social Security Trust Funds to pay for these other things, that right at the time the baby-boom generation starts to retire. That is what leaves us with this very difficult set of choices.

You come here and make a very strong and persuasive case for additional resources. We know that every dollar that you ask for of additional money comes out of the Social Security Trust Fund, and if we don't think that should be done and the American people tell us they don't think that should be done, that leaves us with only two options. If we are to grant your request, that means cutting spending some other place, or raising the revenue to pay for it.

Your answer is add it to the debt, but that means taking out of the Social Security Trust Fund, which the American people have overwhelming told us don't do.

So I say to you and through you to the Administration, I don't think they have come up with the right answer here as to how to pay for these things, and I think we have got an obligation together, if we say these things are needed, to pay for them and not just stick it on the charge card.

Let me go to the other question, the statement that the President made about the axis of evil which you addressed in your opening remarks. Obviously, for us, we have got to determine how we translate what the President is saying into a budget, and should we be preparing a budget that anticipates conflict, military conflict with Iraq, Iran, North Korea. What would your advice be to us in terms of constructing a budget as to what we could anticipate or should anticipate?

Secretary POWELL. The President is not asking for a war budget. The funds that he has asked for the Defense Department essentially are funds needed for transformation, funds needed to deal with problems that hadn't been dealt with in recent years, and to make sure we are ready for whatever contingency may come along.

He has no plan on his desk right now to begin a war with any nation. The nation that is of, perhaps, higher level of concern than others is Iraq. With respect to Iran and with respect to North Korea, there is no plan to start a war with these nations. We want to see a dialog. We want to contain North Korea's activities with respect to proliferation, and we are going to keep the pressure on them, but there is no plan to begin a war with North Korea, nor is there a plan to be in a conflict with Iran. There are many forces at work in Iran, and so I don't think that there is anything that translates into added budget requirements because of his speech.

I think his budget presentation for FY 2003, speaks for itself as to what those funds are needed for.

Chairman CONRAD. You say that there is no plan for conflict, initiating conflict with Iran or North Korea.

Secretary POWELL. The President does not have before him right now, and if he did, I probably wouldn't tell you anyway, but he has no plan before him right now that is a plan for a conflict.

Chairman CONRAD. With Iran or North Korea?

Secretary POWELL. With anybody.

Chairman CONRAD. But you didn't make that differentiation in your remarks with respect to Iraq.

Secretary POWELL. I said that for Iraq, we are always examining options for regime change, but that's what we are doing is examining options. He does not have a recommendation before him that would involve an armed conflict tomorrow.

Chairman CONRAD. Well, tomorrow——

Secretary POWELL. The reason I answer that way, Mr. Chairman, is that there is this feeling in some quarters that we are at a point of starting a conflict, and the President does not have, as he has said, any such recommendation on his desk.

Chairman CONRAD. You know, the important thing for us to know is we have got to construct a budget for the country, and we have got to have some idea in the defense area of what is anticipated. I take your statement for what it is.

I take from what you say that we have got no plan for Iran, for North Korea, and, as you have extended your remarks, no plan in the immediate future, perhaps foreseeable future, with Iraq, but the Administration is examining options with respect to Iraq.

Secretary POWELL. Yes.

Chairman CONRAD. I take that differentiation between what we are doing with respect to Iran and North Korea. I didn't hear that there is an examination of options per se with those countries.

Secretary POWELL. We already have existing policies with respect to both countries.

With respect to North Korea, as I said in my testimony, we have offered dialog. We continue to support the framework agreement of 1994. We continue to provide fuel to North Korea. We are perhaps the biggest, I think we are the biggest, providers of food to North Korea. Those policies have not changed, and we keep 37,000 troops in Korea along with many more South Koreans as a deterrent to North Korean aggression. Those policies haven't changed. What the President did was make sure nobody forgot the true nature of this regime and why we have to be concerned about it.

With respect to Iran, we have had policies in place for a long time. We have some sanctions with respect to Iran in place. We encourage moderate forces in Iran, and we have talked quite candidly to a number of our friends, particularly the Russians, with respect to Iranian ambitions on nuclear weapons development, but we are not at some point drawing up contingency plans to invade Iran.

With respect to Iraq, it has long been for several years now a policy of the United States Government that regime change would be in the best interest of the region, the best interest of the Iraqi people, and we are looking at a variety of options that would bring that about. So Iraq is in a slightly different category than Iran and North Korea, but all bear similar characteristics with respect to the nature of their regimes and to some of the activities that they are conducting with respect to weapons of mass destruction and the means to deliver weapons of mass destruction. That is what sort of puts them in this category.

Chairman CONRAD. When you talk about regime change, I take that to mean some move to force out Saddam Hussein. Are you talking here about military means of bringing regime change? What does it exactly mean when you use those terms?

Secretary POWELL. He could leave in many different ways, from natural causes through other causes, but I don't want to get specific as to possible options. He is exactly the same age I am, and I am constantly looking at the actuarial tables. [Laughter.]

Chairman CONRAD. You look pretty healthy to me.

Secretary POWELL. I believe that I am healthier than he is. I hope I am, anyway.

Chairman CONRAD. Let me ask you one other question, and I referenced this earlier. In the paper today, a group of some 160 organizations have joined together asking for a doubling of overseas aid. The article reports that the Administration has dismissed earlier calls for doubling of foreign aid. When Microsoft's Bill Gates chastised the United States Government for being a laggard in foreign spending earlier this month, Treasury Secretary Paul O'Neill replied that poor countries have collected trillions of dollars in aid over the years with precious little to show for it. Is there precious little to show for the aid that we have extended and the aid that you are requesting that we add to?

Secretary POWELL. I think there is a great deal to show for it, and to put Secretary O'Neill's comments in context, I think what Paul was essentially alluding to was the fact that, in some cases in the past, we did not get the best return on our investment when we provided foreign aid to regimes that were clearly despotic, or during the days of the cold war we had to support a number of regimes that were on the right side of the cold war, but on the wrong side of history. I know this very well, having been National Security Advisor in those days.

We helped a lot of people that we would not have wanted to invite to dinner that night. That was the nature of it, but it is different now.

Now the point I make to anybody who comes into my office and sits down from a developing country is I want to see the rule of law, I want to see a democratically elected government, I want to see transparency in your system, I want to see corruption dealt with. I want to make sure that you are not just interested in aid, except as a way to get to trade. So we can apply different standards now and different rules in this new 21st-century environment that will make sure foreign aid is used appropriately, and there is a return on the taxpayers' investment.

The idea of doubling foreign aid is not a bad idea. I would like to triple it, but there is a reality as to what the budget can stand, as you just vividly pointed out with your very colorful charts. There is a limit.

I believe that what the President has done for the past 2 years, with real increases, is a responsible effort on his part to deal with the kinds of questions we get with respect to why aren't you doing more. And any aid, any money you give me in this Foreign Operations account, I believe it is my obligation to make sure that it is spent in a non-corrupt way and it does not go down a rat hole. Paul O'Neil was alluding to the fact that there have been many cases in the past where it did not pay off, it did not serve the interest of the people.

Chairman CONRAD. Actually, his point was precious little to show for trillions of dollars. As I hear you saying it, do you believe there——

Secretary POWELL. Oh, I think if we were to rack up the trillions of dollars over the years, Secretary O'Neil and I might have to debate that point.

Chairman CONRAD. Senator Byrd, let me just indicate there are a series of votes that have started on the Senate floor now, three votes. They just started the first one. So we will have to ask the other side what they would like to do when we go for these votes.

Senator Byrd.

Senator BYRD. Mr. Chairman, I hesitate to get started on these questions without knowing how far we are into the vote and what the prospects are for our missing vote.

Chairman CONRAD. We are about 3 or 4 minutes into the vote, which would mean we would have about 10 minutes for questioning at this point.

Since there is going to be such a long gap, I hesitate to ask the Secretary to wait.

Senator BYRD. Well, OK.

I thank the Secretary, and I regret that we have scheduled our votes in such a way that we overlook the importance of these committees and the importance of the questions and the answers that may result in our attendance here and the imposition on the time of witnesses like Secretary Powell.

Let me begin by saying that I join in the commendations that have been expressed by our Chairman. I have had a long service with Secretary Powell.

When we debated the IMF Treaty in 1988, I believe it was, I was majority leader for the second time, and Secretary Powell at that time, I believe, was the National Security Advisor to the President.

Secretary Powell complimented the Senate on the work that the Senate did on that treaty. I refused to be pushed and pressed and stampeded into a scheduling for debate of that treaty until we had resolved some very, very important questions raised by the then-Chairman of the Armed Services Committee, Senator Nunn, the then-Chairman of the Intelligence Committee, Senator Boren, the then-Chairman of the Foreign Relations Committee, Senator Pell. I recall that we waited until we got the answers.

The Secretary of State, now-Secretary of State, at that time complimented the Senate on taking the time to resolve these important questions, and Mr. Powell at that time, I think, engaged himself and was active in helping to resolve some of these very important questions.

So he is a man who has made command decisions. He has led men in war. I think he speaks independently. He has the kind of experience that affords him that view, that independence of thought. He doesn't have to just listen to what somebody else says in reports. He has analyzed many of these questions, and I compliment him on his great service to this country.

Our time is limited. There are two questions I would like to ask. Let me premise the first one by what you have said with respect to the President has no plan to attack, there are no recommendations on his desk at this moment. Those are very carefully worded responses to the question by the Chairman, and those of us who have been around here any time at all recognize that they are not direct answers, and I can understand the Secretary.

The President, let me say, though, has made some very bold statements about prosecuting those responsible for the September 11 attacks. The President said that the terrorists are on the run and they will find no safe haven. There is no cave that is deep enough.

He said in the State of the Union Address that the terrorists will not escape the justice of this country. I am with the President 100 percent when it comes to punishing the individual terrorists, those who are still living—some of them died on September 11, which is 5 months ago yesterday—when it comes to punishing those terrorists for the acts of September 11th.

But the President has gone further in naming three states that comprise an axis of evil, and you have used that term, Mr. Secretary, already. Iran, Iraq, and North Korea, the President has said, are arming to threaten the peace of the world, and he will not stand by as peril grows closer and closer. The United States of America will not permit the world's most dangerous regimes to threaten us with the world's most destructive weapons. Those statements have left me wondering. Is the President signaling that we will attack one or more of these countries?

Congress passed a resolution on September 14 to authorize the President to use force against those who carried out, assisted, or gave safe harbor to those responsible for the attack of September 11. Iran, Iraq, and North Korea are not named in that resolution. I have heard no evidence that this axis of evil was responsible for or complicity in the September 11 attacks.

If the President seeks to extend this war on terrorism, a case must be made before Congress and the American people that Iran, Iraq, or North Korea are a clear and present danger to our country.

I, for one, am willing to listen to that case, but to carry out the war, the President will need the sustained support of the American people.

We saw in Vietnam what the lack of support, sustained support for that war, resulted in. If the President wants to crystallize the support of the American people, he would be well advised to seek from Congress a declaration of war. After all, we are not talking about using our military against terrorist cabals. We are talking about war against one or more sovereign states.

Reading many of the news stories about this subject, I have come to a conclusion that while there is no plan perhaps, while there is no recommendation upon the President's desk today perhaps, these matters are evidently being pursued. They are being discussed. They are being considered as options.

Now, when it comes to making war, let's say on Iraq, having been here when you helped to direct the war on Iraq, I possibly could be convinced that we ought to vote. I would vote for a declaration of war, but we are not dealing with Afghanistan if we deal with Iraq.

With respect to Iraq and North Korea, we are dealing with countries that have powerful military forces on the ground, and I would hope, Mr. Secretary, that before we venture into an attack or an invasion or whatever against anyone or more of these countries, the help, the support, the sustained support of the American people would be carefully sought through their elected representatives.

We ought not to go around shooting from the hip, and I think that some of the statements that have emanated from the Administration have alarmed other countries, and they are alarming a lot of people in this country.

Is the President signaling that we will attack one or more of these countries, if he is considering such an attack as a possible course of action? Do you believe, Mr. Secretary, that the President should seek a declaration of war from Congress before unleashing our military might on any one of these sovereign states?

Now, I can understand the inherent powers of the commander-in-chief. If there is an attack about to occur against this country, he has the inherent power to act, but we have time here to discuss these matters, to discuss the case, to debate pro and con, and I personally believe that the President, before he takes such a case, if that is being considered as an option, we had better be very careful to bring the American people in on making the case, and we had better seek a declaration of war from Congress in such a case. That is going to be a very costly venture, if it occurs. It is going to be costly in treasure and in blood, and you knew that as well, perhaps more so than I do.

Unless he has that support, that sustained support, we will be engaged in another very costly and dreadful Vietnam-like venture where the support of the American people vanished. That is one question.

Let me give you one other question, just to conserve my time, and then you can answer them as you see fit. My other question—well, perhaps you better try that one first.

Secretary POWELL. First of all, Senator Byrd, I could not even begin to answer this question without commenting on your opening remarks about the IMF Treaty. It is one of the more vivid experiences of my career to have been, shall I say, taught by you about the Senate's prerogatives with respect to treaties.

I will never forget the meeting you and I and Howard Baker had in your chambers 1 day where you made it clear that the Senate had to give us advice and consent in a measured way only with full information, and I went off to Geneva the very next day to get that full information.

If I may, I will never forget you looking at me and saying, "We will not be hurried by any summit meeting that you all have scheduled or anything else of that nature. We will do our job," and the Senate did do its job. And I thank you for that guidance and that support at that time.

To get directly to your questions, the President's words in the State of the Union speak for itself. He did not declare war on anyone, nor was he saying he was getting ready to declare war on anyone.

In fact, since the State of the Union, he has repeated what he had said two times before the State of the Union with respect to Iraq, let the United Nations inspectors in to determine whether or not you are doing the things we are accusing you of, and if you can establish that you are not doing these things, then the world will be a safer place and you will have dealt with the United Nations.

We still think, it would be better if someone other than Saddam Hussein was running the country. So the President has made no decisions, to repeat myself, and there are no recommendations on his desk, even though as a matter of prudence we should be examining options with respect to all of these countries, but in the first instance we are looking at diplomatic and political means.

We have been eyeball to eyeball with North Korea for 50 years now and trying to make sure that they are contained, this regime that is a despotic regime. So I can assure you that the President is very sensitive first to the feelings and the views and the perspective of the American people, and he is very appreciative of the role that Congress plays in such matters. And I am sure that if he believes some action is taken or some action is required, he will consult with the Congress, and as a result of consultation will make a judgment as to how Congress should be involved in whatever actions are taken, whether it is by declaration of war or a resolution of the Congress supporting an action that is taken pursuant to some United Nations resolution or through the President's inherent right as commander-in-chief to engage the armed forces of the United States.

You will recall what we did at the time of the Gulf War, Senator, with the United Nations resolution we then got a resolution from both houses. So I am sure the President would consult at an appropriate time and determine what he would ask Congress to do, and Congress has, of course, its own inherent power and right to do what it chooses to do.

Senator BYRD. Mr. Secretary, I thank you for that response.

Of course, you and I know that the Constitution does not speak about consultations, nor does it refer to United Nations resolutions. Those are things that have developed over a later time, but the Constitution still says that Congress shall have the power to declare a war, and I believe, as I said earlier, that if the President is contemplating attacking one or more of these countries, I would urge that he not just seek consultation, but he seek a declaration of war. And I might very well vote for that, depending on the case that is made at the time.

My second question. I may miss this vote, and I do that with regret, but I am very appreciative of this opportunity to visit with you across the table and chair and to ask these questions.

By the way, I have cast more roll call votes than any Senator in the history of this republic, and this is not a democracy. This is a republic. But I have cast more votes than any other Senator, and it is a long history. So I don't pass up a vote easily, but I will in this case if I have to.

My second question is this. The President's fiscal year 2003 foreign operations budget request reflects business as usual when it comes to United States aid to Egypt and Israel, but despite providing roughly $5 billion a year, how the Appropriations Committee would like to use that $5 billion a year to help some of the States in this country and the people throughout this country with some of their problems, $5 billion a year in economic and military assistance to the Middle East.

The conflict between the Israelis and the Palestinians continues to worsen. It seems to me that our foreign aid dollars to the Middle East, which have no strings attached that I know about and are not conditioned on any progress being made in the peace process, are being squandered in pursuit of an increasingly elusive peace. This question isn't often laid on the table as plainly as we are doing right now, but I think it ought to be.

Every year, we appropriate roughly $5 billion to these countries, with virtually on questions asked, and they look upon it, I think, as an entitlement, almost as an entitlement. They, I am sure from what I have read and learned, included in their budgets at the beginning of the budget process because, as I say, they look upon it virtually as an entitlement. They can be pretty sure of it.

I think it is top time for questions to be asked. As a result of the current escalation of violence between the Palestinians and the Israelis, the United States seems to be increasing its historic tilt toward Israel and abandoning attempts to negotiate with Yasser Arafat.

Given the continued terrorist attacks by the Palestinians, it is understandable that we are fed up with Arafat, but I have read in the media that even some Israeli reserve soldiers are refusing to serve any longer in the occupied West Bank and Gaza Strip citing the dehumanizing impact of the occupation.

Do you have any concern that the perception of a greater United States tilt toward Israel could prove, and is proving to be, counterproductive by increasing anti-American and anti-Israeli sentiment in the region, by emboldening hard-line Israelis who are opposed to the peace process, and by precluding the United States from fulfilling the role of honest broker in the peace process?

I think, Mr. Secretary, that it is time to put some strings on our foreign assistance in the Middle East and to condition our assistance, to condition our assistance on evidence of progress in the peace process.

I think that would be the axis of my questions. I think it is time to condition our assistance on evidence of progress in the peace process. We have a tool here. We don't seem to use it. Both sides are able to account on a continuation of this money every year, it seems to me. It isn't being used as leverage, as it should be, in pursuit of the peace process, which would be the greatest benefit to both of those countries and to our own country and to world peace.

Yasser Arafat may be unwilling or unable to act on his own, but I have to believe that Egypt and Jordan and hopefully other Arab nations would apply considerably more pressure on the Palestinians if their foreign assistance dollars were at stake, and I have to believe that Israel might be more willing to discuss the issue of Israeli settlements, which are a real bone of contention, in disputed areas if their foreign assistance dollars were at stake.

Mr. Secretary, this is my question. Why shouldn't we condition our assistance to the Middle East? Why shouldn't we use this tool? Why shouldn't we use this leverage on both sides to get them to the peace table and to make them understand that this money is just not going to be had there for the asking, that they have to produce some evidence, they have to show a willingness, they have to act in pursuit of that willingness? That is my question.

Secretary POWELL. Thank you, Senator Byrd.

On the first question, as you know, the roughly 4.6 or close to $5 billion that is spent every year for Egypt and Israel in FMF and ESF funding, are the result of decisions that were made many years ago after the Camp David Accord, and there has been a balance between those two, and as a result, we have a peace agreement between Egypt and Israel. And as part of that, this funding was appropriate to let both sides develop and let both sides feel strong as a result of FMF funding which allows them to maintain their military.

With respect to the situation with the Palestinians and the Israelis, I must say that Egypt has been enormously supportive of our efforts, and Egypt has been applying pressure on Chairman Arafat to get the violence under control, so that both sides can move forward to achieve the kind of peace that you talk about.

With respect to wheter we should we use Egypt's money to pressure them, they are doing what we ask of them now with respect to this. They are putting pressure on Mr. Arafat. They are one of our strongest interlocutors with respect to how we deal with Mr. Arafat. We have not cut Mr. Arafat off. I am in touch with his closest associates, and I spoke to him about 10 days ago.

With respect to the Israelis, they are under attack from terrorist organizations that are linked to the Palestinian Authority. We saw the ship come in with 50 tons of military equipment that escalated the situation, or would have if it had arrived, and to say to them "we are going to cut your funds while you are under these kinds of terrorist attacks unless you do something to reward these terrorist attacks," is not a strategy that I think will be successful.

The strategy we are trying right now and applying right now is to remain committed to the vision of these two states living side by side, remain committed to the Mitchell Plan which provides a path to get there, and committed to the Tenet Work Plan which gets us into the Mitchell Plan, by getting a cease-fire, by getting the violence down.

In recent days, I have been in touch, once again, with the closest aides to Mr. Arafat, talking about the specific things that need to be done, so that we can get the violence down and then see an Israeli response because they now are confident of moving forward into the Mitchell Plan.

The Mitchell Plan talks about settlement activity stopping. The Mitchell Plan talks about opening closures. The Mitchell Plan has everything we need to get the negotiations, negotiations which under appropriate U.N. Resolutions 242 and 338 can lead to a settlement of this crisis and a peace between these two sides. But until Mr. Arafat really is able to crack down, if he can—and I think he still can. I still think he has that authority. People want to push him aside as a leader, but he is still the leader of the Palestinian people. They see him as such, and he is the elected leader of the Palestinian Authority. So I think he has to use his moral authority and his political authority to get the violence down, at which point we can get into a cease-fire and move toward the Mitchell Plan.

We are constantly reviewing the level of funding for both Egypt and Israel, and there is a determination of how it should be allocated between FMF and ESF. We believe they both make solid cases to us every year that justifies the allocation that we have made to them, and that is the case again this year.

We have not walked away from this, and we are always looking for a means by which we could encourage both sides to show restraint, both sides to do everything that is possible to get toward a cease-fire and progress into the Mitchell Plan.

Senator BYRD. Mr. Chairman, I have signaled to the floor leadership that I am willing to give up that vote in order to have been here to ask these questions of Secretary Powell. I gave it up very reluctantly. My attendance record over a period of 44 years, my roll call attendance record, is 98.7 percent of the time. I wouldn't have done that for many Secretaries.

Secretary POWELL. I am honored, Senator Byrd.

Senator BYRD. I thank you for your response to the question. I hope that there will be increased consideration given to my suggestions here as to the use of this assistance. It comes. The American taxpayers give up a lot. They give $5 billion a year to these countries, and there needs to be a return on the taxpayers' investment, I believe, to use your words, in the Middle East. So I hope that there will be increased consideration of using this leverage, and also, Mr. Secretary, I hope you will convey to the President that we need to use our words with care. Words mean something, especially in this context.

We cannot shoot from the hip if we are contemplating as one of the options going into either one of these countries or attacking them. This will be a very sobering, somber, serious matter, and I would appreciate it if you would tell the President about this.

I am not out to pick on the President. I spoke on the Senate floor on Friday about the President and about his speech at the National Prayer Breakfast. I have many good things I can say about the President, but this is very sobering. Some of the words that have appeared to come from the hip from this Administration have caused considerable alarm. I don't have to tell you that. You sense that, I am sure.

Secretary POWELL. Senator Byrd, thank you.

I have been through several crises with the President in our year together, some big, some small. There was the Soviet spy crisis of the early days of the Administration, then the Chinese reconnaissance plane, and then what we have done since September 11th. I have been through many crises in my career with several Presidents. This President does not shoot from the hip, and he does not act from the hip. He handles each one of these with a clarity of purpose, with patience, with prudence, listens to all of the advisors that he has in his Administration, and gathers the support of the American people and his coalition partners as he moves forward.

I am sure that as new challenges arise in the future, particularly if they arise with these three countries or other countries, he will act in a similar manner.

Senator BYRD. I hope so. Thank you.

Chairman CONRAD. Mr. Secretary, I wanted to ask you, as I have indicated before we began, about a comment that was attributed to the Attorney General. Cal Thomas, the broadcaster and journalist, said the Attorney General told him, "Islam is a religion in which God requires you to send your son to die for him. Christianity is a faith in which God sends his son to die for you."

Yesterday, the Justice Department denied the columnist's report, and they said that Ashcroft's statement referred only to the views of terrorists and was not aimed at mainstream Islam or the majority of Muslims. Certainly, I don't know, and I am sure you don't know, what the Attorney General may or may not have said. We were not there. So we can't really testify to that.

I would ask you in terms of the quote that is attributed to the Attorney General, "Islam is a religion in which God requires you to send your son to die for him. Christianity is a faith in which God sends his son to die for you." That is certainly not the way the Administration would characterize Islam. I think the Administration has been very careful, very careful to make clear that this is not a conflict with all of Islam, that this is a conflict with terrorists, people who attack this country in a sneak attack that destroyed the lives of thousands of innocent people, but I wanted to give you an opportunity here.

Secretary POWELL. Thank you, Mr. Chairman.

I believe the way the Justice Department responded is appropriate. I could see Attorney General Ashcroft suggesting that this is what these false leaders say to youngsters to get them to commit these terrible acts of violence, and I am quite sure that does not reflect his views. He has been in the forefront of reaching out to Islamic Americans and others around the world to say that this is a campaign not against any religion or culture or ethnicity. It is against evil people. It is against terrorists.

I also know that John Ashcroft knows as well as I do, or you do, that Islam is not such a religion. It is a religion of peace. It is a religion of reconciliation. It is a religion of love, not a religion of sending people to die for false causes. So I think it must have been out of context, and I think the way the Justice Department handled it was the appropriate handling of the matter.

Chairman CONRAD. I thank you for it. I should add that according to this morning's paper, the Arab-American Institute called the remarks offensive and a horrible distortion of Islam and sent a letter to the President asking that the Attorney General be dismissed if he did not repudiate the statements.

What would your answer be to the Arab-American Institute? Obviously——

Secretary POWELL. I don't know if they had benefit of the response of the Justice Department, but such views do not comport with my knowledge and friendship with John Ashcroft.

Chairman CONRAD. And they are certainly not the views of the Administration. Again, I think the Administration has made very clear——

Secretary POWELL. It is a little unfortunate, but those views, as put in context by the Justice Department, don't reflect the views of John Ashcroft. They reflect views that he was attributing to those who would send the young men to their death that way.

Chairman CONRAD. Very well. I think that is important to get on the record——

Secretary POWELL. Thank you.

Chairman CONRAD [continuing]. And certainly in a timely way, and I appreciate your doing that.

There is another vote on the floor now, and we are not going to ask you to stay. You have been very generous with your time here today.

Let me just conclude as I began by saying you do a superb job as a witness. You really do.

Secretary POWELL. Thank you, Mr. Chairman.

Chairman CONRAD. And I don't say that to many witnesses, but you just do an excellent job making your case.

I make the case back to you, and I know this is not your responsibility in the Administration, but I don't see this budget plan as adding up. I really do not.

If it was just this year, I could be more understanding because of the economic slowdown and the war, but we see here red ink for the next decade in terms of the non-trust fund accounts of the Federal Government. They are not just small, but huge, over $2 trillion being taken from the trust funds in the President's plan to pay for these other matters, a tax cut and other expenditures of the Federal Government. That is going to make future choices extraordinarily difficult for a future Congress and a future President.

My own view is if we want to spend this money, we have got an obligation to pay for it. This generation just can't send the bill to our kids.

Some people have asked me, why are you so fixed on this? Well, I am fixed on it because I have got a daughter. She is here in the audience, as a matter of fact, wanted to hear you. She has made a special study of Islam, learned Arabic. I know that some point down the road, she is going to turn to me and say, "Dad, you were Chairman of the Budget Committee. What were you doing when you guys ran up these big debts?" I want to be able to say I confronted it, I said what was going to happen and tried to do something about it, and I very much hope the Administration will come back with a plan as to how we are going to cope with these deficits and debt because I think just as it presented a huge problem for the company of Enron, it is going to present a huge problem for our country. This money is owed. It is ultimately going to be paid, and those that ran up the tab, I think, got the obligation to pay it.

So, with that, again, Mr. Secretary, thank you.

Secretary POWELL. Thank you, Mr. Chairman. I will take your message back to my colleagues, and let me take this opportunity, again, to thank you for the strong support you have provided to the Department. It is very much appreciated, and your support of me as well, sir. Thank you.

Chairman CONRAD. Thank you very much.

[Whereupon, at 11:33 a.m., the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSAL

WEDNESDAY, FEBRUARY 13, 2002

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

The committee met, pursuant to notice, at 11:19 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad (chairman of the committee) presiding.

Present: Senators Conrad, Murray, Byrd, Clinton, and Grassley.

Staff present: Mary Ann Naylor, staff director; and Dakota Rudesill, analyst.

For the minority: G. William Hoagland, staff director; and Winslow Wheeler, senior analyst.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

First, I want to apologize to the Secretary and Mr. Zakheim. There have been a series of votes on the floor, unfortunately, starting immediately this morning, and I had responsibility for carrying the debate on the first two amendments, and all of our colleagues are on the floor because of this series of votes. And we apologize very much for that. We had to delay the hearing until 10:45, and now here we are at 11:20 and it has still not begun.

I understand the Secretary has other obligations at 12:30, and we will respect that.

I also want to indicate that Senator Domenici is again not able to be with us today because of health considerations. We wish him a very speedy recovery and anxiously await his return to the committee and the work of the committee.

I am going to make a brief opening statement, and then we will turn to the Secretary for his statement and then go to questions.

As we meet here today, we first have to acknowledge the circumstances that we confront as a Nation. Obviously everything changed after the sneak attack on this country of September 11th. That altered in a very dramatic way the priorities of the Congress and the President.

We also have an obligation to talk about our long-term economic security, and this first chart shows the President's budget as his budget numbers describe it, and they show that we are going to be in deficit if we exclude the trust funds through this entire decade, and that we will be using $2 trillion of trust fund money to pay for tax cuts and other spending. We are doing that right at the time the baby-boom generation is getting ready to start retiring.

They will begin retiring in just 6 years. And so we have to have these fundamental facts inform the decisions of the committee.

The implications of this dramatic turnabout in our budget circumstances are these: Last year, we were told we had $2.7 trillion of non-trust fund surpluses over the next decade. Now we are told by the Congressional Budget Office we have $2.2 trillion of deficits when we put aside the trust funds of Social Security and Medicare.

That means every dime of that deficit is coming out of the trust funds of Social Security and Medicare, $2.2 trillion taken from those funds over the next decade. Obviously, that has major implications for the country.

When we look to the President's budget and we look at the priorities, the funding over baseline—and the baseline is last year's spending amount adjusted for inflation, adjusted for number of people eligible for the various programs—what we see is the biggest increase goes to homeland security, some 23 percent over the baseline; defense is 10 percent over the baseline. Let me make clear, defense is increased more than that over last year's spending, but the baseline adjusts last year's spending for inflation. And so this is the amount over the baseline. And international affairs has a slight increase over the baseline. All other domestic programs are reduced 6 percent.

Let's go to the next that shows the billions of dollars, and, again, this is over the baseline. Homeland security is $5 billion over the baseline; defense, $36 billion; international affairs, $400 million. Everything else is being reduced by $23 billion from the baseline.

Now, the next chart looks at it in dollar terms, not in relationship to the baseline. This looks at it in dollar terms, and we have got a request from the President of $48 billion over last year: $10 billion of that is inflation, $5 billion is the change to an accrual system, moving from discretionary accounts—or from mandatory accounts to discretionary accounts, retirement costs of those who are working in defense. There is a $10 billion contingency fund and $23 billion of what we would call new spending.

We do not have a supplemental for 2002 from the President. This is one of the curious elements of his budget. There is no supplemental before us for 2002. There is for 2003, but not for 2002, and perhaps we can inquire about that today.

Putting in perspective what we spend on defense, the President's request is a total of $396 billion, and if we look at that in comparison to the other major nations in the world, what we see is we are spending more than the next 18 combined. We are spending more than Russia, Japan, China, and the next 15 combined. So we are making a very substantial commitment to national defense.

Over the 10 years, we see the President requesting, over and above the baseline, $656 billion of additional spending for defense. This is an extraordinary buildup that puts us back to cold war levels of spending, and we are going to have to consider very closely how that all fits in with the need and the commitment not to take Social Security funds for other purposes. We are going to have to consider the other priorities of the Nation, the tax cuts that have been previously passed.

Let me just go to a statement that was made by the former Vice Chairman of the Joint Chiefs of Staff, Admiral Owens, on February 4th of this year, when he said, “Return to the defense spending heights of the mid-1980’s is not necessary to win the war on terrorism or to transform our armed forces. In fact, it could be quite counterproductive. Availability of such large sums of money will reduce incentives to eliminate costly redundancies in our force structure tooth, but particularly in the tail of defense bureaucracy and support organizations. The truth is that we already have all the money for defense we need, so long as we undertake real reform and spend it better.”

Well, that is the view of the former Vice Chairman of the Joint Chiefs of Staff, who has testified before this committee previously, somebody that I think all of us respect. He is a military leader who had a significant impact on the transformation of our military forces now underway.

With that, Mr. Secretary and Comptroller Zakheim, thank you very much for being here. I especially want to thank you for your patience this morning, and we will turn to you now for your statements, and then we will go to questions.

Again, welcome to the committee, and before you start, I would just like to thank you on behalf of all Americans for what has to have been an extraordinary period since the Pentagon itself was attacked, since we lost lives there, since the extraordinary decisions that have had to be made. We appreciate your service to the country, and we thank you on behalf of all Americans for what you have done.

Mr. Secretary, if you would like to proceed?

STATEMENT OF PAUL WOLOWITZ, DEPUTY SECRETARY, UNITED STATES DEPARTMENT OF DEFENSE, ACCOMPANIED BY DOV S. ZAKHEIM, UNDER SECRETARY OF DEFENSE/COMPTROLLER, UNITED STATES DEPARTMENT OF DEFENSE

Mr. WOLFOWITZ. Mr. Chairman, since time is short and I know you read well, I won’t try to go through the whole prepared statement, but if I might just sort of summarize what I consider some of the high points.

First of all, to begin with the obvious, the world changed in dramatic ways on September 11th, and I think our attitudes toward defense changed in dramatic ways. I have to say that for those of us who were saying even before September 11th that we had to review affordability in light of what we were buying with our defense investment, it seems to me that, unfortunately, September 11th is a demonstration of the fact that these capabilities, while expensive, are a bargain when you consider what they buy the country in the long run, and that we are indeed investing in peace and security, not just for our generation but for our children and grandchildren. And it is an investment that we mustn’t stint on.

In the Defense Department today, because of September 11th, we are trying to do three things at once: to win the war on terrorism, to restore the capabilities of and maintain the capabilities of our current force by making appropriate investments in procurement, people and modernization, and by accelerating the transformation of that force to prepare for the challenges of the decades to come to really build the 21st century military.

We can only accomplish that with appropriate investments over a sustained period, and we have to do it in an environment of rising costs, particularly rising costs for that most critical element of the force, our people.

Mr. Chairman, you, like many others, have made the comparison of this budget with budgets of cold war periods. Frankly, it depends on which period you pick. There were times when I think we clearly underspent during the cold war, and to some extent we are now living off the investment that was made in the 1980's. But the point I want to make here is that we couldn't buy today's cold war forces at those old prices, and particularly we couldn't buy the quality people that we need to maintain this force, and we couldn't equip and train them properly at cold war prices.

I think the comparison isn't terribly accurate. I believe, in fact, it is much more appropriate to talk, as we have been talking, about the much smaller burden as a percent of GDP that our current budget sustains.

But as an illustration of those rising costs for people, the 2003 budget not only covers—and my number is a little different than yours. We can try and see where the difference lies. We say $6.7 billion of straight inflation, but another $14 billion in "must pay" bills for retiree health care and pay raises.

If you add on to that the $7.4 billion to account for what we think was unrealistic prior estimates of costs for procurement and operation and investment for the war on terror, which is $19.4 billion, you actually come to a total of $47.6 billion. So you can see that even though the President submitted a request for a $48 billion increase, a very large increase and the largest increase since the early 1980's, we have got to dig into current programs and find savings if we are going to actually make new investments.

We have been able to do that. We have made new investments. I think we are, in fact, significantly changing the course on which the Department of Defense is steering. It is like steering a super tanker. You don't turn an establishment of 2 million people, or 2 million-plus if we count all the civilians, overnight. You wouldn't want to. It would be a big mistake to try. But I think the Quadrennial Defense Review that was published at the end of September, but which was completed, largely completed before September 11th, sets a substantial new direction for the Department of Defense, one that was the product of literally hours of very close discussion and debate among the Secretary of Defense and his senior civilian and military advisers.

I mention in the testimony some of the changes: the change from the two Major Theater War force sizing construct; the emphasis on a capabilities-based approach to account for the uncertainties of the future; and, third—and the one that I would like to elaborate on just briefly here—the effort to put some definition on what we mean by transformation. "Transformation" is a popular word, at least in the defense policy think tanks. Lots of people mean different things by it. I would like to underscore it can't mean transforming 100 percent of your force overnight. It means more something like transforming 10 percent of it by the end of a decade. But if you change that 10 percent, you, in fact, change the capability of the entire force, and that is what we aim at doing.

One of the things we did in the QDR was to define very precisely the six highest priority areas of transformation, and as one of my coworkers who spent a good deal of time before coming to our office working on transformations on the Joint Staff said, having that kind of definition is very critical, that before that, people come up with a lot of ideas and they feel like they are spinning wheels. When you start to say which are the ideas that you are most interested in and you start to put money behind those ideas, you energize the system in a way that I don't think can simply be quantified.

I am going to try to quantify it here a little bit, though, because in every one of the six categories that we have identified, we have significant increases in this year's budget.

Overall, we have roughly a $21.1 billion investment in programs that, by a pretty strict standard, count as transformational programs. I might say that transformation may be in the eye of the beholder. If you asked an Air Force General, he might say that every dollar spent on the F–22 is transformational. We are not counting the F–22 as a transformational program, although it certainly transforms the way in which we will do air-to-air combat. But by this much stricter standard, some $21.1 billion, or 17 percent of the total we are spending on RDT&E and procurement, is in these transformational initiatives, and that is an increase of roughly 25 percent over what was in those programs in the previous FYDP. Thirty-five percent is a significant rate of increase, and the people working those programs I think realize that they are the stars of the Defense Department these days.

Let me just go through them briefly. Again, you can read the statement. The first and highest priority, I think—and September 11th only confirmed what we had concluded before September 11th—is protecting our bases of operation and particularly our homeland. This year's budget not only includes $7.8 billion of investment in a refocused and revitalized missile defense program, but some $8 billion in support of defense of the United States homeland and forces abroad. In total, over the FYDP, a $45.8 billion increase in this category, and an increase of 47 percent over the previous 5-year Forward Year Defense Program.

In addition to that, under the homeland security category, there are other things that are funded in the costs of the war, particularly combat air patrols over United States cities.

A second crucial transformational priority and one whose importance has been demonstrated very strongly in Afghanistan is our capability to deny enemies sanctuary and to do that particularly by exploiting new capabilities for a long-range precision strike. Some people, I think, thought long-range precision strike was just a new synonym for victory through air power. But, in fact, long-range precision strike involves ground forces as well and might sometimes be primarily ground forces. And what we saw in Afghanistan was the remarkable combination of very brave United States Army and Air Force people on the ground, literally on horseback, on a 19th century military capability, calling in strikes from 50-year-old B–

52s and truly transforming the battlefield and transforming the course of the war.

It is something that could not have been done without what modern communications and modern connectivity make available. But to a considerable extent, as that example demonstrates, transformation isn't just about new systems. It is about using old systems in new ways. And when Secretary Rumsfeld was asked about this project of bringing the horse cavalry back into modern warfare, he said, only half jokingly, "It's all part of our transformation plan."

The budget also includes $1 billion to convert four Trident nuclear submarines from the cold war mission of delivering nuclear weapons to a 21st century mission of conventional strike from under the sea. That is truly transformational. It was a hard choice. We could have taken that $1 billion and built new ships and had a better looking shipbuilding program. We think on balance that investment in SSGN is a very important and valuable capability.

And, by the way, to give you the illustration of the fact that we are not throwing everything and the kitchen sink under the heading of transformation, there is another $1.7 billion in this budget that isn't counted as transformational, but that is funding for JDAMs and other precision guided munitions that are, frankly, critical to making transformation work.

Just by the stricter definition, we have $3.2 billion in programs in this category, an increase of 157 percent—$16.9 billion of the FYDP, and that is an increase of 157 percent.

The third category is countering anti-access efforts and, forgive me, "anti-access" I guess is Pentagon jargon. But what it refers to is the very determined effort by those around the world who wish us ill or think that they may oppose us at some point in the future to figure out to deny us access to operating areas, either by attacking our ships on the sea or by denying us bases. One of the answers to that is long-range. Another answer is stealth. Another answer is the ability to deploy ground forces rapidly and in a natural, flexible way. The budget requests $7.4 billion in programs in that category, $53 billion over the FYDP, and that is an increase of 21 percent.

Fourth, and very important, is leveraging information technology. That, in the example of the B–52s and horse cavalry, is in many ways the key to making that work. And I might also take the opportunity to point that transformation is also about cultural change. The more you have this ability to communicate, the more people's jobs change in dramatic ways.

I had a briefing not so long ago by an Air Force group that included an F–15 pilot. This young woman had to be persuaded to not take a rated pilot's job and instead fly a Predator aircraft from a location in the United States. I suppose Admiral Owens would count her as part of the tail, but I think she is definitely part of the tooth.

It is a whole different view in the Air Force of what a career as a fighter pilot can mean, and, believe me, it takes a lot of cultural change to persuade a hot-shot F–15 pilot to fly a Predator. But it is the kind of thing that we are doing. We have to do more of it.

We are also investing to do that, and this year's budget includes $2.5 billion for programs to support this objective of leveraging information technology, $18.6 billion over the FYDP, and that is an increase of 125 percent.

Again, there are very important things that are not fully covered in that $2.5 billion. Overall, I asked the staff to give me a total on what we are investing in command-and-control communications infrastructure in the 2003 budget, and the total comes to $5.5 billion. And in that total, to me what is most exciting is the investment in laser communications. Laser communications are a promising although still experimental technology that, if successful, would give wideband satellites the ability to pass data to each other at speeds measured in gigabits per second as opposed to megabits per second, which is currently the case. And anyone who knows the difference between a dial-up modem and a DSL line realizes that that kind of difference is dramatic in terms of what you can do. But beyond that, if you want to talk about very complicated, unmanned aerial vehicles, especially combat aerial vehicles, unmanned aerial vehicles, you have to have that kind of increase in the communications backbone.

Fifth, conducting effective information operations. As we become more and more dependent on these very complex communications grids, information grids, we have got to be able to protect ours, and we have to be able to attack the enemy's. The 2003 budget requests $174 million for programs in this category and $773 million over the FYDP, an increase of 28 percent.

Finally, we identified space as a priority for transformation. Space actually played a role in the war in Afghanistan, but not a huge role. But space is the ultimate high ground, and one of our top transformational goals has to be to harness United States advantages in space to enable us to see what adversaries are doing around the world and around the clock. And in doing so, we must also ensure the survivability of our space systems.

The 2003 budget requests about $200 million to strengthen space capabilities and $1.5 billion over the FYDP, an increase of 145 percent.

As I said, the goal is not to transform the whole force or to do it all at once. Transformation, as the Secretary said, is not an event. It is an ongoing process.

Let me just note briefly, but by no means to neglect its importance, that this budget continues to put its highest priority on taking proper care of our people. The budget requests $94.3 billion for military pay and allowances. It also includes $4.2 billion to improve military housing, putting the Department on track to eliminate most substandard housing by 2007. We are also on track to eliminate all out-of-pocket housing costs for men and women in uniform by 2005 by increasing base allowance for housing.

We worked hard to find savings. We are going to continue working hard in the future. The Secretary has emphasized that "because we are at war" cannot become an excuse for paying for things that we don't need. Indeed, to the contrary, because we are at war, we have to take a very hard look at things that we don't need.

In this year's budget, we canceled programs that we felt were not in line under the new defense strategy or were having difficulties.

Those included the DD–21, the Navy Area Missile Defense, 18 Army Legacy programs, and the cold war Peacekeeper Missile. We also accelerated a retirement of a number of aging systems, including the F–14, the DD–963, and accelerated retirement of Vietnam-era helicopters.

Overall, we were able to find some $9.3 billion in program savings and program adjustments, and, quite frankly, that is why we are able to do serious new investment despite those "must pay" bills that I cited at the beginning of my testimony.

Mr. Chairman, to conclude, let me just say that, yes, this is a big budget; yes, this is a big increase. But I think to compare it to what we spent in the cold war, as I said, is misleading because you can't buy cold war forces, even if they were the right ones to buy, and they are no longer the right ones to buy.

It is also misleading, I think very much so, to compare our budget to other countries' budgets. We don't fight other countries' budgets. We fight their forces. The budget of the Taliban would have been a minuscule fraction of what the United States has. It was very important that we had the capability to deploy forces in a totally unforeseen part of the world on very short notice and do it with that kind of effectiveness.

I think that we do have by far the best military in the world. We need the best military in the world. A budget of $379 billion represents a great deal of money, but when you consider just economic costs alone of the September 11th attack and the economic importance of being able to prevent future attacks by going after the terrorists and taking down those terrorist networks, I think the investment is clearly worth it. When you consider the cost in human lives and the pain and suffering of so many thousands of Americans who lost loved ones that day, I think the value is incalculable.

Quite frankly, since so much of this committee's focus has got to be on the long term and on the future of many other accounts, I would underscore that I think nothing is more important than preserving peace and security for future generations. And I believe that this, while a large investment, is an appropriate investment for that objective.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Wolfowitz follows:]

THE PREPARED STATEMENT OF PAUL WOLFOWITZ, DEPUTY SECRETARY OF DEFENSE

Mr. Chairman and Members of the Committee: Given the many difficult choices with which you are faced, I appreciate the opportunity to return to this Committee to help you in your task by addressing the 2003 defense budget. Since we met last summer, a great deal has changed, of course. I look forward to addressing some of these changes with you.

One of the greatest—and gravest—changes was brought by September 11th—a day that changed our Nation forever. September 11th has taught us once again that when it comes to America's defense, we must spend what is necessary to protect our freedom, our security and prosperity—not just for this generation, but to preserve peace and security for our children and our grandchildren.

Today, we are engaged in the enormously preoccupying task of fighting a global war on terrorism. As difficult as it is to think about other challenges in the middle of waging this war, it is essential that we think beyond this great effort if we are to face the security challenges and conflicts that are certain to arise throughout this century.

The 2003 Defense Budget request meets the challenges of the current campaign as well as other priorities that are essential to ensuring that America's Armed Forces can manage the threats and challenges of the decades ahead.

When the cold war ended, the United States began a very substantial draw down of our defense forces and our budgets. We cashed a large "peace dividend," lowering the level of our defense burden by half from the cold war peak. Much of that was an appropriate adjustment to the great improvement in our security that resulted from the end of the cold war. The draw down, however, ultimately went too far.

While our commitments around the world stayed the same and even grew in some cases, our country spent much of the 1990's living off investments made during the cold war, instead of making new investments to address the threats of this new century. As I discussed with this Committee last year, even before September 11th, we faced the urgent need to replenish critical accounts. After September 11th, we find ourselves facing the additional challenges of accomplishing three significant missions at once:

We must win the global war on terrorism;

We must restore capabilities by making investments in procurement, people and modernization; and,

We must prepare for the future by transforming for the 21st Century.

It will be difficult and demanding to tackle all three of these missions at once, but we must do it—and without delay. Even as we fight the war on terror, potential adversaries study our methods and capabilities, and they plan for how they can take advantage of what they perceive to be our weaknesses and vulnerabilities. Now is precisely the moment we must begin to build forces that can frustrate those plans and provide us with the capabilities we need to win the wars of the coming decades.

We can only accomplish the Defense Department's three missions—fighting the war on terror, supporting our people and selectively modernizing the forces we have now, and transforming our Armed Forces for the wars of the future—with proper investments over a sustained period. And we must accomplish these missions in an environment of rising costs, particularly for that most critical element of the force—our people—so vital to our success. The 2003 budget addresses "must pay" bills such as retiree health care and pay raises ($14.1B); and other bills such as realistic costing ($7.4B); inflation ($6.7B): and the war on terror ($19.4B). Added together, these bills come to $47.6 billion. That is why President Bush sent to Congress a 2003 defense budget request of $379 billion—a $48 billion increase from the 2002 budget, and the largest increase since the early 1980's.

New Defense Strategy

The 2003 budget request was guided by the results of last year's strategy review and the Quadrennial Defense Review (QDR), both of which involved an unprecedented degree of debate and discussion among the Department's most senior leaders. Out of this intense debate, we reached agreement on the urgent need for real changes in our defense strategy.

I might add that our conclusions have not gone unnoticed. One foreign observer reports that the QDR contains "the most profound implications" of the four major defense reviews conducted since the end of the cold war. What is most compelling about this analysis is that it appears in a Chinese journal. That Chinese observer thinks the QDR's conclusions are important as a blueprint for where we go from here—and we think so, too.

My statement today addresses how the President's budget intends to meet this blueprint, shaped by the needs of the environment we face today and the environment we could face in the decades to come.

Among the new directions set in the QDR, the following are among the most important:

First, we decided to move away from the two Major Theater War (MTW) force sizing construct, which called for maintaining forces capable of marching on and occupying the capitals of two adversaries and changing their regimes—at the same time. The new approach instead places greater emphasis on deterrence in four critical theaters, backed by the ability to swiftly defeat two aggressors at the same time, while preserving the option for one major offensive to occupy an aggressor's capital and replace the regime. By removing the requirement to maintain a second occupation force, we can free up resources for various lesser contingencies that might face us and also be able to invest for the future.

Second, to confront a world marked by surprise and substantial uncertainty, we agreed that we needed to shift our planning from the "threat-based" model that has guided our thinking in the past to a "capabilities-based" model for the future. We don't know who may threaten us or when or where. But, we do have some sense of what they may threaten us with and how. And we also have a sense of what capabilities can provide us important new advantages.

Third, this capabilities-based approach places great emphasis on defining where we want to go with the transformation of our forces. Transformation, as Secretary Rumsfeld has said, "is about an awful lot more than bombs and bullets and dollars and cents; it's about new approaches, it's about culture, it's about mindset and ways of thinking of things."

We identified six key transformational goals that define our highest priorities for investments in the 2003–2007 FYDP.

-First, to protect the United States homeland and forces overseas;
-Second, to project and sustain power in distant theaters;
-Third, to deny enemies sanctuary, or places where they can hide and function.
-Fourth, to protect information networks from attack;
-Fifth, to use information technology to link up United States forces so they can fight jointly; and
-Sixth, to maintain unhindered access to space—and protect United States space capabilities from enemy attack.

We reached these conclusions before September 11th, but our experiences since then have validated many of those conclusions, and reinforced the importance of continuing to move forward in these new directions. The 2003 budget request advances each of the six transformational goals by accelerating funding for the development of the transformational programs and by funding modernization programs that support transformation goals.

The budget requests $53.9 billion for Research, Development, Test, and Evaluation (RDT&E)—a $5.5 billion increase over fiscal year 2002. It requests $71.9 billion for procurement—$68.7 billion in the procurement title—a $7.6 billion increase over fiscal year 2002—and $3.2 billion in the Defense Emergency Response Fund. It funds 13 new transformational programs, and accelerates funding for 22 more existing programs.

All together, transformation programs account for roughly $21.1B, or 17 percent, of investment funding (RDT&E and procurement) in the President's 2003 budget request—rising to 22 percent over the 5-year FYDP. Let me discuss the details of the $21.1 billion in each of the six categories that follow.

1. Protecting Bases of Operation/Homeland Defense.

It is obvious today that our first goal, protecting our bases of operation and homeland defense, is an urgent—priority especially since we know that both terrorists and state-supporters of terrorism are actively looking to build or buy nuclear, chemical and biological weapons of mass destruction.

To meet our objective of making homeland defense the Department's top priority, the President's 2003 budget funds a number of programs. These include:

$300 million to create a Biological Defense Homeland Security Support Program to improve United States capabilities to detect and respond to biological attack against the American people and our deployed forces.
$7.8 billion for a refocused and revitalized missile defense research, testing and procurement program that will explore a wide range of potential technologies that will be unconstrained by the ABM Treaty after June 2002, including:
$623 million for the Patriot PAC III to protect our ground forces from cruise missile and tactical ballistic missile attack.
$3.5 million for the Mobile Tactical High-Energy Laser that can be used by United States ground forces to destroy enemy rockets, cruise missiles, artillery and mortar munitions.
$598 million for the Airborne Laser (ABL), a speed of light "directed energy" weapon to attack enemy ballistic missiles in the boost-phase of flight—deterring an adversary's use of WMD since debris would likely land on their own territory.
$534 million for an expanded test-bed for testing missile intercepts;
$797 million for sea, air and space-based systems to defeat missiles during their boost phase, which includes the $598 million for ABL.

The budget invests $8 billion to support defense of the United States homeland and forces abroad—$45.8 billion over the 5-year Future Years Defense Plan (2003–7), an increase of 47 percent from the previous FYDP. In addition, the budget funds combat air patrols over major United State cities ($1.2B) and other requirements related to this transformation goal.

2. Denying Enemies Sanctuary.

The President's budget funds a number of programs to ensure adversaries know that if they attack, they will not be able to escape the reaches of the United States. As we root out al Qaeda and members of the Taliban, it is readily apparent how important it is to rob our enemies of places to hide and function—whether it be in caves, in cities, or on the run.

Key to denying sanctuary is the development of new capabilities for long-range precision strike, which is not just about heavy bombers, but about linking ground and air assets together, including unmanned capabilities. It also includes the ability to insert deployable ground forces into denied areas and allow them to network with our long-range precision-strike assets.

This is something we have seen in the campaign in Afghanistan. Our Special Forces, mounted on horseback, have used modern communications to communicate with and direct strikes from 50-year-old B–52s. Introducing the horse cavalry back into modern war, as Secretary Rumsfeld has said, "was all part of the transformation plan." And it is. Transformation isn't always about new systems, but using old systems in new ways with new doctrines, new types of organization, new operational concepts.

The President's 2003 budget funds a number of programs designed to help us meet our objective of denying sanctuary to enemies. They include:

$141 million to accelerate development of UAV's with new combat capabilities.

$629 million for Global Hawk, a high-altitude unmanned vehicle that provides reconnaissance, surveillance and targeting information. We will procure three Air Force Global Hawks in 2003, and accelerate improvements such as electronics upgrades and improved sensors, and begin development of a maritime version.

$91 million for the Space-Based Radar, which will take a range of reconnaissance and targeting missions now performed by aircraft and move them to space, removing the risk to lives and the need for over-flight clearance;

$54 million for development of a small diameter bomb, a much smaller, lighter weapon that will allow fighters and bombers to carry more ordnance and thus provide more kills per sortie;

$1 billion for conversion of four Trident nuclear submarines into stealthy, high endurance SSGN Strike Submarines that can each carry over 150 Tomahawk cruise missiles and up to 66 Special Operations Forces into denied areas;

$30 million for advanced energetic materials and new earth penetrator weapons to attack hardened and deeply buried targets.

$961 million for the DD(X), which replaces the canceled DD–21 destroyer program and could become the basis of a family of 21st Century surface combat ships built around revolutionary stealth, propulsion, and manning technologies. Initial construction of the first DD(X) ship is expected in fiscal year 2005.

The 2003 budget requests $3.2 billion for programs to support our objective of denying sanctuary to America's adversaries, and $16.9 billion over the 5-year FYDP (2003–7) an increase of 157 percent.

3. *Projecting Power in Anti-access Areas.*

Projecting and sustaining power in anti-access environments is another necessity in the current campaign; circumstances forced us to operate from very great distances.

In many other cases, United States forces depend on vulnerable foreign bases to operate creating incentives for adversaries to develop "access denial" capabilities to keep us out of their neighborhoods.

We must, therefore, reduce our dependence on predictable and vulnerable base structure, by exploiting a number of technologies that include longer-range aircraft, unmanned aerial vehicles, and stealthy platforms, as well as reducing the amount of logistical support needed by our ground forces.

The President's 2003 budget includes increased funds for a number of programs designed to help us project power in "denied" areas. These include:

$634 million for an expanded, upgraded military GPS that can help United States forces pinpoint their position and the location of their targets with unprecedented accuracy.

$5 million for research in support of the Future Maritime Preposition Force of new, innovative ships that can receive flown-in personnel and off-load equipment at sea, and support rapid reinforcement of conventional combat operations. Construction of the first ship is planned for fiscal year 2007.

$83 million for the development of Unmanned Underwater Vehicles that can clear sea mines and operate without detection in denied areas;

About $500 million for the Short Takeoff/Vertical Landing (STOVL) Joint Strike Fighter that does not require large-deck aircraft carriers or full-length runways to takeoff and land.

$812 million for 332 Interim Armored Vehicles protected, highly mobile and lethal transport for light infantry enough for one of the Army's transformational Interim

Brigade Combat Teams (IBCT). The fiscal year 2003–2007 Future Years Defense Program (FYDP) funds six IBCTs at about $1.5 billion each.

S707 million for the Army's Future Combat System a family of advanced-technology fighting vehicles that will give future ground forces unmatched battlefield awareness and lethality.

$88 million for new Hypervelocity Missiles that are lighter and smaller (4 ft long and less than 50 Ibs) and will give lightly armored forces the lethality that only heavy armored forces have today?

The 2003 budget requests $7.4 billion for programs to support our goal of projecting power over vast distances, and $53 billion over the 5-year FYDP (2003–7) an increase of 21 percent.

4. *Leveraging Information Technology.*

A key transformation goal is to leverage advances in information technology to seamlessly connect United States forces in the air, at sea and on the ground so they can communicate with each other, instantaneously share information about their location (and the location of the enemy), and all see the same, precise, real-time picture of the battlefield.

The President's 2003 budget funds a number of programs designed to leverage information technology. These include:

$172 million to continue development of the Joint Tactical Radio System, a program to give our services a common multi-purpose radio system so they can communicate with each other by voice and with data;

$150 million for the "Link–16" Tactical Data Link, ajam-resistant, high-capacity, secure digital communications system that will link tactical commanders to shooters in the air, on the ground, and at sea providing near real-time data;

$29 million for Horizontal Battlefield Digitization that will help give our forces a common operational picture of the battlefield;

$61 million for the Warfighter Information Network (WIN–T), the radio-electronic equivalent of the World Wide Web to provide secure networking capabilities to connect everyone from the boots on the ground to the commanders.

$77 million for the "Land Warrior" and soldier modernization program to integrate the small arms carried by our soldiers with high-tech communications, sensors and other equipment to give new lethality to the forces on the ground;

$40 million for Deployable Joint Command and Control a program for new land- and sea-based joint command and control centers that can be easily relocated as tactical situations require.

The 2003 budget requests $2.5 billion for programs to support this objective of leveraging information technology, and $18.6 billion over the 5-year FYDP (2003–7) an increase of 125 percent.

5. *Conducting Effective Information Operations.*

As information warfare takes an increasingly significant role in modern war, our ability to protect our information networks and to attack and cripple those of our adversaries will be critical.

Many of the programs supporting this objective are classified. But the President's 2003 budget funds a number of programs designed to provide unparalleled advantages in information warfare, such as $136.5 million for the Automated Intelligence, Surveillance and Reconnaissance System, a joint ground system that provides next-generation intelligence tasking, processing, exploitation and reporting capabilities.

The 2003 budget requests $174 million for programs to support this objective—$773 million over the 5-year FYDP (2003–7) an increase of 28 percent.

6. *Strengthening Space Operations.*

Space is the ultimate "high ground." One of our top transformational goals is to harness the United States advantages in space where we can see what adversaries are doing around the world and around the clock. As we move operations to space, we must also ensure the survivability of our space systems.

The President's 2003 budget includes funds for a number of programs designed to provide unmatched space capabilities and defenses. These include:

$88 million for Space Control Systems that enhance United States ground based surveillance radar capabilities and, over time, move those surveillance capabilities into space;

$103.1 million for Directed Energy Technology to deny use of enemy electronic equipment with no collateral damage, to provide space control, and to pinpoint battlefield targets for destruction.

The 2003 budget requests about $200 million to strengthen space capabilities—$1.5 billion over the 5-year FYDP (2003–7) an increase of 145 percent.

Of course, we cannot transform the entire military in 1 year, or even in a decade nor would it be wise to try to do so. Rather, we intend to transform between 5–10 percent of the force, turning it into the leading edge of change that will, over time, lead the rest of the force into the 21st Century. As Secretary Rumsfeld has emphasized, "transformation is not an event—it is an ongoing process."

PEOPLE/MILITARY PERSONNEL

While we transform for the future, we must take care of our most valuable resource: the men and women who wear our Nation's uniform. Military service by its nature asks our service members to assume certain risks and sacrifices. But, we should not ask those who put themselves in harm's way to forego competitive pay and quality housing.

The President's 2003 budget requests $94.3 billion for military pay and allowances, including S. 1 .9 billion for an across-the-board 4.1 percent pay raise.

The budget also includes $4.2 billion to improve military housing, putting the Department on track to eliminate most substandard housing by 2007 several years sooner than previously planned. It will also lower out-of-pocket housing costs for those living in private housing from 11.3 percent today to 7.5 percent in 2003 putting us on track to eliminate all out of pocket housing costs for the men and women in uniform by 2005. This represents a significant change before 2001, out-of-pocket costs were 18.8 percent.

We stand by our goal of reducing the replacement rate for DoD facilities from the current and unacceptable 121 years, to a rate of 67 years (which is closer to the commercial standard). We have dedicated some $20 billion over the 2003–7 FYDP to this end. But most of those investments have been delayed until the out-years, when BRAC is finally implemented and we will know which facilities will be closed.

The budget also includes $10 billion for education, training, and recruiting, and $22.8 billion to cover the most realistic cost estimates of military healthcare.

COST SAVINGS

We have taken a realistic approach in looking at a number of programs, and have found areas where we can save some money. We have proposed terminating a number of programs over the next 5 years that were not in line with the new defense strategy, or were having program difficulties. These include the DD–2 1, Navy Area Missile Defense, 18 Army Legacy programs, and the Peacekeeper Missile. We also accelerated retirement of a number of aging and expensive to maintain capabilities, such as the F–14, DD–963 destroyers, and 1000 Vietnamera helicopters.

We have focused modernization efforts on programs that support transformation. We restructured certain programs that were not meeting hurdles, such as the V–22 Osprey, Comanche, and SBIRS programs. Regarding the V–22, the production rate has been slowed while attention is focused on correcting the serious technical problems identified by the blue ribbon panel and a rigorous flight test program is to be conducted to determine whether it is safe and reliable. The restructured programs reflect cost estimates and delivery dates that should be more realistic.

We are working to generate savings and efficiency in other programs as well. For example, today, the B–1 bomber cannot operate effectively in combat environment where there is a serious anti-aircraft threat. So the Air Force is reducing the B–1 bomber fleet by about one third, and using the savings to modernize the remaining aircraft with new precision weapons, self-protection systems, and reliability upgrades that will make the B–1 suitable for future conflicts. This should add some $1.5 billion of advanced combat capability to today's aging B–1 fleet over the next 5 years without requiring additional dollars from the taxpayers. These are the kinds of tradeoffs we are encouraging throughout the Department.

We are also proceeding toward our goal of a 15 percent reduction in headquarters staffing and the Senior Executive Council is finding additional ways to manage DoD more efficiently.

The budget reflects over $9 billion in redirected funds from acquisition program changes, management improvements, and other initiatives savings that help to fund transformation and other pressing requirements.

Currently, to fight the war on terrorism and fulfill the many emergency homeland defense responsibilities, we have had to call up over 70,000 guard and reserves. Our long term goal, however, is to refocus our country's forces, tighten up on the use of military manpower for nonmilitary purposes and examine critically the activities that the United States military is currently engaged in to identify those that are no longer needed.

The Secretary of Defense and the Defense Department have made one of the highest reform priorities to put our financial house in order. We have launched an aggressive effort to modernize and transform our financial and non-financial management systems to include substantial standardization, robust controls, clear identification of costs, and reliable information for decision makers. Especially key is the creation of an architecture that will integrate the more than 674 different financial and non-financial systems that we have identified.

Congress's decision to put off base-closure for two more years means that the Department will have to continue supporting between 20–25 percent more infrastructure than needed to support the force. The decision to hold up the process another 2 years will be a costly one for taxpayers. Additionally, because of the post-September 11th force protection requirements, DoD is forced to protect 25 percent more bases than we need.

The 2-year delay in base-closure should not ibe taken as an opportunity to try to "BRAC-proof" certain bases and facilities. Earmarks directing infrastructure spending on facilities that the taxpayers of America don't need and that eventually could be closed would be compounding the waste that the delay in BRAC is already causing.

TRADE OFFS

Throughout this budget process, we were required to make some tough tradeoffs. We were not able to meet our objective of lowering average age of tactical aircraft. However, we are investing in unmanned aircraft, and in the F–22 and JSF, which require significant upfront investments, but will not come on line for several years. While the budget proposes faster growth in Science and Technology (S&T), we were not able to meet our goal of 3 percent of the budget. And we have not been able to fund shipbuilding at replacement rates in 2003 which means we remain on a downward course that, if not unchecked, could reduce the size of the Navy to a clearly unacceptable level in the decades ahead. To sustain the Navy at acceptable levels, the United States needs to build eight or nine ships annually. The proposed Future Years Defense Plan budgets for procurement of 5 ships in fiscal year 2004, 7 ships in 2005, 7 ships in 2006 and 10 ships in 2007.

CONCLUSION

A budget of $379 billion represents a great deal of money. But, consider that the New York City comptroller's office estimated the local economic cost of the September 1th attacks on New York City alone will add up to about $100 billion over the next 3 years. Estimates of the cost to the national economy range from about $170 billion last year and estimates range as high almost $250 billion a year in lost productivity, sales, jobs, airline revenue, and countless other areas. The cost in human lives, and the pain and suffering of so many thousands of Americans who lost loved ones that day is incalculable.

The President's budget address our country's need to fight the war on terror, to support our men and women in uniform and modernize the forces we have, and to prepare for the challenges of the 21st Century. This Committee has provided our country strong leadership in providing for the national defense and ensuring that taxpayers dollars are wisely spent. We look forward to working with this Committee in achieving both of these critical goals.

Chairman CONRAD. Thank you very much for your statement, and, again, welcome. We are glad to have you here.

Let me go to your last statement. You indicate the importance you attach to the increase that is being sought. As I indicated in my opening, the President's budget indicates that all of this increase is going to be coming out of Social Security funds. Many of us, including the President, pledged not to use those funds for other purposes. If there is a determination by the Congress and by this committee not to fund it in that way, to fund the increase that you are seeking but not to fund it in that way, would you support cutting other programs that are in the President's budget or making revenue adjustments, increasing taxes in order to pay for this priority? Is it sufficiently important that it needs to happen and so important that you would support cutting other spending or raising taxes to get this job done?

Mr. WOLFOWITZ. Mr. Chairman, I feel like we have a huge job in the Defense Department, not only making our contribution, which is a big one, to the war on terrorism, but trying to manage this budget, which is a big one, and make hard decisions about what to invest in and looking hard to find savings. I don't feel that that leaves me the time or the competence to make the kinds of decisions that Mitch Daniels has to make and the President himself has to make about balancing priorities.

I appreciate very much the way in which they have found what I think are adequate resources for defense, and I know it hasn't been easy, and I know it is not easy up here for the Congress. I would just say that we in the Defense Department very much value the support that we are getting from the President and the support we have been getting from the Congress. And I am not going to try to venture into terrain that I am really not equipped for.

Chairman CONRAD. All right. We will put you down as a duck on that question. [Laughter.]

Chairman CONRAD. As we prepare this budget, the President has made very strong statements about Iraq and Iran and North Korea. Should we be preparing in this budget for conflict, military conflict with Iraq?

Mr. WOLFOWITZ. Let me say that the $10 billion that we put in as a contingency fund for continuing operations into fiscal year 2003 really doesn't contemplate a large military conflict of the kind you refer to. It is based on what we think is a prudent assumption that this war isn't going to be over in 12 months, that we are going to be continuing operations into fiscal year 2003, that we should make some provision for it rather than pretend that we are not going to spend any money and then come around at the last minute looking for additional funding.

Ten billion dollars is an estimate based on the assumption that we continue at roughly the level of operations we have been conducting for the last 3 or 4 months, and that $10 billion at that rate will get us almost halfway into fiscal year 2003.

If those assumptions were different, for example, take the case that you hypothesize that we have a major war with Iraq—and I think a war with Iraq would be a major war—then clearly we would have to be back for a different level of funding. But there is a limit to how much you can crystal-ball the future. We just thought it was appropriate to make some provision for the fact that we do think we are going to still be conducting an unusually high level of military operations in fiscal year 2003.

Chairman CONRAD. What about 2002? You have got a 2003 supplemental, but there is no 2002 supplemental. Does that mean you will not be seeking supplemental funds for 2002?

Mr. WOLFOWITZ. No, it doesn't. We in effect do already have a 2002 initial supplemental. It is what is left over from the 2001 supplemental that the Congress very helpfully passed and very quickly, and Dr. Zakheim can help us through how much of that is still left. A lot of it did carry over into this fiscal year. But it is only going to carry us for a little while longer. We will have to have supplemental funding in 2002 to continue operations and——

Chairman CONRAD. Why wasn't that in the budget? It is a very curious thing to us. It is a very curious thing. If the funds are needed, why wasn't it put in the President's budget submission to Congress?

Mr. WOLFOWITZ. Because the President's budget submission is for fiscal year 2003, and we are now talking about supplemental funds for operations in 2002. It is really the same principle as what I outlined for the 2003 budget, which is a large enough supplemental so that you don't have to come up here at the very beginning of the fiscal year asking for supplemental funding. But you don't try to have such a large contingency fund that you will conduct a war for 12 months without an idea of what the circumstances are.

Chairman CONRAD. Do you have any sense of how big the 2002 supplemental might be?

Mr. WOLFOWITZ. We are working very hard on trying to define it. And, again, Senator, it is going to be a guess because we are talking about a very unpredictable course of military operations. We do know that just based on the current level we are going to need a supplemental probably before the middle of the year. We are going to need supplemental funding passed before the middle of the year. And we are working right now on what are the most plausible assumptions.

Ideally, we would like to hit a number that is exactly right fiscal year 2002 so that we never have to come back again, but we also don't want to be excessive in what we ask for.

Chairman CONRAD. Could you give us some range of what that 2002 supplemental might look like?

Mr. ZAKHEIM. Well, as the Deputy Secretary just said, it is hard to do. We know certain things already, Mr. Chairman. We know that in certain categories of the operation we are now undertaking, Joint Staff is telling us that they will be running out of funds as early as April. That sets a certain degree of urgency to what we are doing. But at the same time, the earlier we would come in with a supplemental, the less likely it is we can accurately predict how things would play out between whenever the supplemental is passed and the end of the fiscal year.

So as the Deputy says, we are trying our very best to get our arms around just what exactly is needed to maintain the current level of operations between whenever the supplemental is passed and September 30th. That is, frankly, the reason why we didn't send anything up with the 2003 budget because we still had to see what were we doing in January and what would be doing in mid-February so that we could have the best possible estimate and the least possible distortion of what the supplemental would look like relative to the operations through the end of the year.

Chairman CONRAD. You know, it is unusual, let me just say, it is unusual for us to have a 2003 budget submission by the President and no 2002 supplemental or no heads-up on what that supplemental might look like. But I am not trying to be critical here. I understand the difficulties. You are trying to get a handle on it. It would be very helpful to us. We have got to write a budget, and we have got to try to understand the relationships between 2002 and 2003. And—the miracle of cell phones.

It would be very helpful if we could get as soon as possible some indication on a range of what that supplemental might look like.

I have heard—let me ask it this way: I have heard that we may be in the range of $20 billion. Does that seem in the ballpark, or is that much too low or much too high? Can you give us some sense?

Mr. WOLFOWITZ. Do you want to take a guess?

Mr. ZAKHEIM. Sure. I am happy to guess as long as it is treated as a guess.

We know that based on what happened in the congressional action on the 2002 budget, we were short $5.5 billion in operations and maintenance. That means that given the ongoing operation in Afghanistan, you can see that that is almost a baseline, if you will. Beyond that, what we are trying to do, first of all, is to make sure that what is in this supplemental really relates to the war, just like the previous supplemental did; and, second, that we bear in mind that we do have the $10 billion contingency funding that begins on October 1st. And so we are really talking about something not for an entire year, but for a portion of the year.

We would hope to get this to the Congress as soon as possible once we have our handle on a reasonable estimate, precisely for the reason you just gave. You have your regular order of business. You have to put a budget together. We understand that. We need your support on our 2003 budget, so, of course, we are going to try to do it as expeditiously as possible. We have to be responsible about the numbers.

Chairman CONRAD. But my question was, and I—that wasn't my question. My question was: What are we talking about? I have heard $20 billion through the grapevine. Is $20 billion in the range or is it way too high? Is it way too low? I mean, you must have some idea. Here we are, it is February, we have got to write a budget in the next 6 weeks.

Mr. ZAKHEIM. I am just very hesitant to—it is a guess. We will try to get to you very quickly with something that is better than a guess. I am very hesitant here in public to put a number out that then ultimately, you know, it is too high or it is too low, or it will be underbudgeted, it will be overbudgeted.

Chairman CONRAD. I am not going to press you further. I just say to you it would be very helpful to us if you could get us—we really—even a range would be very helpful because somehow we have got to try to get all this to add up, and we don't have much time.

Mr. WOLFOWITZ. I understand that.

Senator BYRD. Mr. Chairman, would you entertain a cumulative question on that point?

Chairman CONRAD. Yes, I would.

Senator BYRD. Is this supplemental request going to include homeland security? Is there going to be a supplemental for homeland security?

Chairman CONRAD. Could the witnesses advise us of would it be strictly defense or would it be homeland security as well in this supplemental?

Mr. WOLFOWITZ. I really can't speak for other departments or for OMB. I would be surprised if other departments don't also have some expenses that aren't properly covered.

Chairman CONRAD. Let me just say that if we could send a message to the Administration through you, it is really very important not only to this Committee, which must make judgments on budgets very quickly—we have a requirement to be done April 1st, and you can see that we are up against an incredibly tight timeframe. It also has very significant impact on the appropriators, and the discussions that are going on right now between budgeteers and appropriators with respect to division of funds, that is a critically important piece, and we need to know quickly what the Administration will be asking for.

Mr. WOLFOWITZ. We will certainly convey that, and we have the same interest you do, because if we don't have a clear idea pretty soon of when we are going to run out of money, we are going to have to start affecting the way we operate, and that is painful.

Chairman CONRAD. All right. Senator Grassley?

Senator GRASSLEY. I am going to use my time just to make a statement, Mr. Chairman.

First of all, I want to compliment Secretary Rumsfeld for a really revolutionary attitude within the Department of Defense. And I don't want you to think I am getting soft when I compliment a Secretary of Defense. But he said this on September 10th last year: "Every dollar we spend was entrusted to us by a taxpayer who earned it by creating something of value with sweat and skill. A cashier in Chicago, a waitress in San Francisco, an average American family worker works an entire year to generate $6,000 in taxes. Here"—meaning at the Pentagon—"we spend many times that amount every hour by duplication and by inattention. That's wrong. It's wrong because national defense depends on the public trust, and trust in turn hinges on a respect for the hard-working people of America and the tax dollars they earn. We need to protect them and their efforts."

I think 9/11 wiped out any lingering doubts that any of us had about the intentions of terrorists. It is crystal clear that they want to kill Americans, and as many as possible. And I don't doubt for a second that they will strike again and that we have to be prepared for it. We must not allow American citizens to live with constant fear that moment of terror will come again. This is a threat to our way of life. As Americans, we cannot accept that. The terrorist threats must be eliminated.

I think President Bush is doing everything possible to restore and maintain our security at home and abroad. And I know that the war on terrorism is not going to be cheap. I accept that. Right now we have no choice. So I don't want to quibble with you and your budget, particularly on the details of them, because for winning the war you have to have all of our support.

But I would like to take some time to warn about some of the things that Secretary Rumsfeld has alluded to, and that is about waste, and I am going to skip two or three pages about some history of my involvement with it because I don't think that is important right now. So I want to give kind of a warning, Mr. Secretary: Find a way to control waste. Unfortunately, you have a major obstacle to overcome before you can get a handle on waste. You can't begin to control waste until you know what things cost, and you will never get a handle on costs until your books of account are in order. Every shred of evidence that I have examined over the years tells me that the books at the Department of Defense are in shambles.

The gentleman sitting beside you, your chief financial officer, I think knows exactly what I am talking about. The best barometer on the quality of bookkeeping at the Pentagon are the annual audits or the financial statements. The results are dismal because of over $150 billion in financial transactions for which there is no supporting documentation. Criminals could be tapping into your pipeline and you would never know it.

During Secretary Rumsfeld's nomination hearing last year before the Senate Armed Services Committee, he was grilled by our colleague here, Senator Byrd, about the very same problem. As a result of that exchange, Senator Byrd and I cosponsored a financial management oversight initiative. It was enacted at Section 1009 of this fiscal year's defense authorization bill. Having accurate financial information at your fingertips is a key to controlling waste, and right now I don't think that the Department as it. You need to get it, and Senator Byrd and I and others want to help you get there.

Mr. Secretary, obviously you and your colleagues have your work cut out for you. For starters, I think you need to get an IG in place, an inspector general in place. With the Pentagon money spigot being wide open now to win the warm on terrorism—we accept that—I think there should be a new IG operating at a high state of alert. A 3-year oversight investigation of the IG's office tells me that it is not ready today. That office has serious management problems. The new IG would need to clean house.

In sum, Mr. Secretary, I am asking you to control waste, clean up the books, get a handle on costs, and please don't fritter away this golden opportunity to rebuild the armed forces. Waste is a constant danger at the Pentagon. Secretary Rumsfeld said that in that statement I read from. When we send military personnel into harm's way, I want to be confident that they have what they need to get the job done, and if you allow waste to spin out of control, the troops will be the first ones to suffer.

Thank you. And I would like to put a longer statement in the record.

Chairman CONRAD. Certainly that will be done.

Senator GRASSLEY. Thank you.

[The prepared statement of Senator Grassley follows:]

THE PREPARED STATEMENT OF SENATOR CHUCK GRASSLEY

Mr. Secretary, the 9/11 attack wiped out any lingering doubts I had about the intentions of the terrorists. Their intentions are now crystal clear: Kill as many Americans as possible. And I don't doubt for a second that they will strike again when they think the time is right. We must not allow American citizens to live with constant fear that moment will come again. This is a threat to our way of life. As Americans, we cannot accept that. The terrorist threat must be eliminated.

I think President Bush is doing everything possible to restore and maintain our security at home and abroad. I know the war on terrorism will not come cheap. I accept that. Right now, we have no choice. So I won't sit here today and quibble with the details of your budget. You have my support.

But I want to warn you about waste. Big budgets breed waste, and the Pentagon has a world-class reputation for waste and mismanagement. Waste is lurking out there in the shadows—just waiting for you to open the money spigot. If you fail to keep a lid on waste, support for the Bush defense buildup will evaporate quickly.

The troops in the field will end up on the short end of the stick. And the Senator from Iowa will be on your back.

Mr. Chairman, a little piece of local history might help everyone in this room understand where I am coming from. Back in the early 1980's at the height of the cold war, President Reagan launched a massive military military buildup that was fiercely debated in the Senate. Mr. Chairman, I want the witnesses to understand that this was a defining experience for me. It still shapes my thinking on defense. I was convinced—almost from day one—that President Reagan's defense Secretary "Cap" Weinberger [Cap the Ladle] was bent on throwing huge sums of money at problems better solved by structural reform and some real leadership. So I did what I could to stop it.

As a conservative Republican, this was not easy to do. But I did it because it was right. And I ll do it again if I have to. I offered an amendment to freeze the defense budget. That was on the fiscal year 1986 budget resolution. My amendment was adopted on May 2, 1985.

That act alone threw a monkey wrench into the last big plan to ramp up the defense budget. But more than anything else, it was the spare parts honor stories in the early 1980's—the $750 pair of pliers, the $750 toilet seat, and the $7,000 coffee pot—that changed my thinking on defense forever. The spare parts horror stories were a turning point. They convinced me that the Pentagon's defense buildup was a colossal taxpayer rip-off. They undermined the credibility of the planned defense buildup and turned me into a defense reformer. They drove me to watchdogging, digging into waste, fraud and abuse at the Pentagon. And I am still at it today, and I will be at it again tomorrow.

So, that is my warning to you, Mr. Secretary: Find a way to control waste. Unfortunately, you have a major obstacle to overcome before you can get a handle on waste. You can't begin to control waste until you know what things cost. And you will never get a handle on costs until your books of account are in order. Every shred of evidence I have examined over the years tells me your books are in a shambles. Your Chief Financial Officer—Mr. Zakheim—who is sitting next to you knows exactly what I am talking about.

The best barometer on the quality of bookkeeping at the Pentagon are the annual audits of your financial statements. The results are dismal because of over $150 billion in financial transactions for which there is no supporting documentation. Criminals could be tapping into your money pipe, and you would never know it.

During Secretary Rumsfeld's nomination hearing last year, he was grilled by Senator Byrd about the very same problem. As a result of that exchange, Senator Byrd and I co-sponsored a financial management oversight initiative. It was enacted as Section 1009 of the fiscal year 2002 defense authorization bill. Having accurate financial information at your fingertips is a key to controlling waste, and right now you don t have it. You need to get it, and Senator Byrd and I want to help you get there.

Mr. Secretary, you have your work cut out for you. For starters, you will need a junkyard dog. You need to get your IG nominee in place. With the Pentagon's money spigot wide open, I want the new IG operating at a high state of alert. A 3-year oversight investigation of the IG's office tells me that it is not ready today. That office has serious management problems. The new IG will need to clean house.

In sum, Mr. Secretary, I am asking you to control waste. Clean up the books and get a handle on costs. Please don't fritter away this golden opportunity to re-build the Armed Forces. Waste is a constant danger in the Pentagon. When we send military personnel into harm's way, I want to be confident that they have what they need to get the job done. If you allow waste to spin out of control, the troops will be the first ones to suffer. And I will be on your back.

Question?

With the Pentagon money spigot wide open, how will you control waste? What exactly will you do?

Mr. WOLFOWITZ. Senator Grassley, if I could make three points very quickly, and I know Dr. Zakheim has some things to add. First of all, we feel as strongly about waste after September 11th as we did when the Secretary made that statement on September 10th. And he has repeatedly emphasized to people that the spigot isn't open, that now that we are fighting a war, waste is even more costly. I believe that it is a responsibility that lies with the Congress as well as with the Administration, and I can't help but register my unhappiness that the BRAC was delayed another 2 years.

We are now spending some $4 billion to $5 billion in enhanced security for bases some 20 percent of which we don't need anymore. We need to do our work. We need cooperation from the Congress.

Second, if I could appeal—because you are absolutely right about the IG. Now finally, I think our nominee has cleared both the Committees that have to review him, and we would appreciate speedy confirmation.

Finally, on the very important point about financial management which you raised just now, and which I know Senator Byrd raised at length with the Secretary in his confirmation hearings, we have taken that message very seriously. I think we have invested money and time in trying to work at that problem. It is still pretty awful, but there is a lot of improvement, and I might ask Dr. Zakheim to hopefully talk more about the improvement, please, Dov.

Mr. ZAKHEIM. OK, sure. Senator, and Senator Byrd, I assured you both that this was going to be as high a priority for me as just getting a budget out the door, which has tended to be the way some of my predecessors looked at financial management as somehow second-order priority.

We have done a number of things. I shook up my front office for starters. I have a new acting deputy chief financial officer. But more important than that, we have made some significant changes already in terms of how we are approaching the problem, both in the short term and in the long term.

For instance, in the short term, we have set up new training courses for dealing with reconciliation with the Treasury books. There are people that actually know how to do this sort of thing, which many of them didn't. We are encouraging the Society of Military Comptrollers to get more people for training. Our people aren't as well trained as they should be, and we have certain limitations from OPM as to how we set up professional requirements for people that, quite frankly, I feel hamstrung, but within those limitations we are doing quite a bit more.

We went to the Defense Contract Accounting Office, DCAA, our auditors, in effect, have—another part of my office that had never talked to the Financial and Accounting Service, and yet they were able to increase the level of competence of their people and I got them talking to each other, and DFAS has picked up on some of their changes.

The standards for accounting, for years the Department of Defense resisted accounting for major end items. I did a complete 180 and instructed my staff to agree with the Federal Accounting Standards Board that we should indeed have valuation for major end items which then would show up on the balance sheets, and they will for the first time. This was a reversal of 10 years of absolute stonewalling by the Defense Department. I came in from business. I couldn't understand how you couldn't value assets.

We have established, as I promised we would, a Business Practice Implementation Board, all people from the outside, from banking, from business, to come in and tell us what we are doing wrong, what we should be doing better. I have the Comptroller General of the General Accounting Office as ex officio on that board. I invited him. I have the Comptroller of OMB ex officio on that board.

We are reaching out to the folks who have criticized the Department for years and said to them, OK, we are making the change, help us do it. Help be part of the solution, not part of the problem.

I would also add that on acquisition——

Chairman CONRAD. Let me, if I could just ask that—we have got three Senators left, and you guys want to be out of here by 12:30.

Senator GRASSLEY. I thank you all very much, and thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator for his excellent questions. The Senator from Iowa has been very dedicated to try to make certain that there is not waste and that we straighten up the financial management, and we recognize his contributions.

Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman.

Mr. Secretary, I believe that our fight against terrorism and homeland defense are inextricably linked, and to me one of the most obvious examples of this linkage is the question that is pending before the Department of Defense right now regarding the deployment of National Guard personnel to assist with security missions along our Northern and Southern borders.

As you probably know, late last year Attorney General Ashcroft announced that the Federal Government would send the National Guard to our borders to supplement agents from the INS and Customs. In my home State, this news was met with an enormous relief because it had a serious impact on our borders with the lack of personnel. It has had an impact on our communities, their economies and families, and we were relieved to hear that.

But since that announcement, the Federal Government has made very little progress toward actually deploying these National Guard personnel, and I understand the legal and organizational challenges when we are attempting to determine how to best deploy National Guard assets. But I want you to know that every day spent negotiating the fine print of an MOU is another day of gridlock and economic hardship for border communities across our country, but particularly in Whatcom County in my home State.

Now, I know that the Department of Defense is very close to having in place MOUs with the Department of Justice. I think there is some work to be done with the Department of Treasury. But my question to you today is: Will you authorize the immediate training of National Guard personnel for the upcoming border missions? We want to do everything we can to speed the deployment, and it seems to me that if we begin the training immediately, that will be one way to get this moving quickly. Can you authorize that?

Mr. WOLFOWITZ. Senator Murray, I don't know whether we can authorize it absent the memorandum of agreement. But I agree with you that those should get done and done quickly, and I, in fact, spoke with people just yesterday about my frustration that it is taking so long.

I will look into the question of whether we could start the training in advance of the MOA's. That would make a lot of sense if we can speed up the process.

Senator MURRAY. I would really appreciate it, and if you have the authority to waive them, if you can do that and move this along, we would greatly appreciate it. It is needed. If you don't, if you can tell us what we can do to make that happen or if the Secretary of Defense or Director Ridge or the President can do anything, we need to get this done and we need to get it done as quickly as possible. And the training, we don't want that to be a barrier to getting those folks out there.

Mr. WOLFOWITZ. I guess I would also appreciate any help you can give us on making sure that those other departments start recruiting and training their own people because this is meant as a 6-month stop-gap until they have their own people. So both pieces of training need to get going, and going quickly.

Senator MURRAY. I would agree. What we all want is the INS and Customs to have their own people in place. But in the meantime, we have tremendous economic hardship because we don't have enough people to do the job we are requiring them to do for homeland defense.

I know that the MOU's are talking about 179 days. Can you tell me what the rationale on the 179 days is?

Mr. WOLFOWITZ. Principally that that is the period of time for which we call up National Guardsmen and Reservists, and it seemed like a reasonable period of time for the INS and other—I mean, I don't think we should start thinking of the men and women who volunteer to serve their country in uniform as just being a readily available pool of manpower. They are not.

Senator MURRAY. And I would agree with you. But defending our borders is something that we need to do.

Mr. WOLFOWITZ. We are going to step up to our piece of it, and it is very important, particularly when we look at the kinds of budget demands on this Department, it is very important that other agencies not just leave us holding the bag indefinitely.

Senator MURRAY. Well, I would agree, but I hope we can work with you if we have to extend it beyond 179 days. I mean, our whole goal here is, of course, to fully staff Customs and INS. That is an appropriations and a budget issue as well. But if we can't, I hope we can work with you to make sure that the border is staffed and appropriately done so if it goes beyond 179 days.

And let me ask you about the reimbursement because I know that is one of the key issues that is holding things up. It is temporary, but it is a Federal responsibility, and I hope we don't let disputes over reimbursement prematurely end this deployment. And I hope the Department of Defense encourages the President to request supplemental funds for this mission, particularly if it goes beyond the 179 days.

Mr. WOLFOWITZ. I will check into that.

Senator MURRAY. OK. I would appreciate that. Again, Mr. Secretary, I can't emphasize enough the importance of this issue to my constituents and really to people all along the Northern border. It is a very real Federal issue, and it is having an enormous impact on our border communities. You know, it is not a debate among military lawyers in my State. It is about people who are losing their jobs and their livelihood and our communities losing our tax bases. And we have got a lot of people who are waiting to see if the Federal Government is going to follow their commitment on this.

Mr. WOLFOWITZ. Well, I appreciate hearing that from you, and it may help us clear away a little bit of the bureaucracy. It is important.

Senator MURRAY. Good. I hope so, if we can get it done quickly. Thank you.

Mr. WOLFOWITZ. Thank you.

Chairman CONRAD. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. And I thank you, Mr. Secretary. On several occasions today, you have suggested that it is your hope that the Congress will support your budget, that you would need Congress' support. And as one who has been here 50 years, I have seen Congress giving the Defense Department support. Over these 50 years, we fought a cold war during which Congress provided the wherewithal needed to wage that cold war, and eventually that cold war was won through our efforts.

So when you keep referring to the need for congressional support, remember, it is a two-way street. And the Chairman has just a minute ago brought forth—and no one answered—the two questions, the accurate responses to which this Committee vitally needs. So let's phrase that as a two-way-street approach. We need your support in helping us to understand what we are going to be asked for and when. We can't just give you a blank check. We can't just say, yes, you will have our support. We were elected by the people, and we will need your support and getting these answers to us so that this Committee can do its work.

Let me raise again the question concerning the big budget that has been presented to the Committee. Here we are being asked for a 15 percent increase for defense over last year. And last year we provided a 10 percent increase over the previous year. And we are being told that domestic discretionary spending is going to be limited to a 2 percent increase, generally speaking. We are being asked for a budget that amounts to more than $1 billion a day. That is a big number.

And we are also being asked for a $10 billion fund that I suppose it is expected, we will be expected to say yes to that without knowing more about the details. I am a little reluctant to go down that road without more information than we have.

About 6 or 8 months ago, I talked with Secretary Rumsfeld—or maybe it was a lot longer ago than that—about the fact that in the defense budget the Defense Department could not account for, I think it was, $3.5 trillion out of a $7.6 trillion account. And Secretary Rumsfeld indicated he was going to try to get to the bottom of that, and he has tried. I think Congress has provided the Department's request for $100 million to tackle this serious accounting problem.

I want to say again that Secretary Rumsfeld was disturbed about that. It didn't happen on his watch, but he indicated he was disturbed, and he was going to do something about it. And he has been working on that. So I compliment him.

Can you tell us how this $100 million is being used? And will you need more in the fiscal year 2003 budget?

Mr. WOLFOWITZ. Let me ask Dr. Zakheim to answer that specific question, but I would like to say very clearly, Senator Byrd, I don't know what I said that left a different impression. I believe we have had outstanding support from the Congress in this war and over decades, and I am not trying to flatter you. I know you personally have been a great supporter of the Defense Department. I didn't mean to imply anything other than the fact that I think we are in this together. We have had great bipartisan support, and we need to keep it up. And when it comes to difficult decisions that involve cutting out things that we don't need to do anymore, that is often a special problem up here because it may be something that we don't need to do anymore, but it involves jobs and involves closing bases.

I in no way meant to say we know what—that we have any—I think it is just an outstanding relationship, and I could not be happier with the support we have had from the Congress over the last few months since September 11th.

Senator BYRD. Thank you.

Mr. WOLFOWITZ. On the specific issue of the $100 million, let me ask Dr. Zakheim to address that.

Mr. ZAKHEIM. Very briefly, Senator, what we are doing with that is creating a blueprint that will guide the way we invest in the future. You are absolutely right, huge sums of money unaccounted for. Part of the problem is that our systems are too numerous and too old and don't talk to one another. We have already catalogued them, 674 of them. So there is room for so much in the way of error, and, frankly, our civil servants are very honest. But, boy, is there room for fraud, Senator.

So we are trying to clean that up. We are using the money for that. We are asking for an additional $97 million this year. It is going to take time and money. But we do have a blueprint, and we will be happy to brief you, either directly or for the record, to give you more details.

Senator BYRD. Well, thank you. If the Defense Department can't account for $3.5 trillion—and I think there is a more recent report on that. For example, the Department of Defense Inspector General reported in September that out of $4.4 trillion worth of accounting interest—now, this is a later report, you see. Out of $4.4 trillion worth of accounting interest processed by the Department, $1.1 trillion were not supported by proper research, reconciliation, or audit trails.

Now, if the Department of Defense can't account for these, can't account for this huge inventory that it has, doesn't know where the pieces are, what pieces are there, what pieces are missing, how can the American taxpayers expect the Department of Defense to spend and increase budget of the kind that is being presented to this Congress? There needs to be better accounting. We have talked about this before. You are trying. But this is our problem, too. How can we go forward and appropriate these huge increases in the defense budget while letting many other important policies and budgets throughout the Government be starved of funds, in some cases reduced? How can we be expected—what do the taxpayers of America expect us to do?

We need answers to these questions. Here we are presented with a huge budget, and I also can remember when Secretary Rumsfeld was before the Committee, and I complimented him on this review that he was beginning, the review of the current systems in the Defense Department. I complimented Secretary Rumsfeld. I said I think you are doing the right thing. There are too many rivalries between and among the branches. There is too much overlapping. So go to it. Let's have this kind of review.

Well, the review started. It was going forward. It has been delayed. But then came September 11. I don't know what happened to that review. I am wondering whether or not the Deputy Secretary could tell the Committee at this point—perhaps he may need a while to collect his thoughts and his facts, and he may to followup on this question for the record. But what among the old systems did that review indicate should be changed or should be perhaps ended? It seems to me that when September 11th came, the review stopped, and as I look at the increased budget request for defense, I wonder if we aren't still going pell-mell down the same old road, supporting the same old systems that were intended for the cold war, which was won, and then we are not going to have the benefit of the transformation that the Secretary was expecting to be able to recommend.

Mr. WOLFOWITZ. Senator, I think actually you came after my opening statement. We have, I think, a number of ways of identifying the results of that review, and the Secretary is very determined to continue down that road. He does have his hands full playing his role in managing the war, but he has kept the pressure on about transformation. He has kept the pressure on about looking for savings. He has kept the pressure on about not simply insisting on increases in manpower, although there are definitely increases in what we are asking the military to do today. And he has put a lot of emphasis on working on cleaning up that backlog that you correctly pointed to in his confirmation hearing.

Many of those are, I think technical issues that can be cleared up, where it is not a matter that no one has any idea what the money went to, but that the documentation hasn't been assembled properly. My understanding is it is an embarrassingly large number, but it is now down below $1 trillion. It is $700 billion. And Dr. Zakheim is working on bringing it down hopefully as fast as possible and to build new systems so that we don't start accumulating another large backlog of that kind.

But you are absolutely right that this is hard-earned taxpayer money and we better be able to explain where it goes. And it should——

Senator BYRD. Mr. Chairman, do I have time for another question?

Chairman CONRAD. You do, sir.

Senator BYRD. I thank the Chairman.

Mr. Secretary, there are a couple or three questions I would just ask, and I know we don't have time for you to answer them, but there is one I want to get into a little bit. One of those questions I would like to delve deeply into is with respect to the $10 billion reserve fund. This is, in effect, a request for Congress to write a very large blank check to the Pentagon. For the moment, I will put that question aside, and we will have opportunities when we have hearings in the Appropriations Committee.

Another question I would like to develop but won't have time for here is the matter of having this four-star general for homeland defense. This is a matter I would like to go into at another time. Perhaps I won't have the opportunity here, but there will be other forums.

The one thing I would like to touch upon is a question which I touched upon yesterday with Secretary of State Colin Powell. And I read a story in the New York Times this morning about our policy toward Iraq. The article says that over the next 3 months the President will make a big push to get U.N. weapons inspectors back into Iraq, and they really expect Saddam Hussein to throw up the same roadblocks that led to the expulsion of the inspectors in 1998. The article goes on to say that the President will use this as justification to pursue more forceful action against Iraq.

Now, I don't shed any tears for Iraq, and I don't have very much sympathy for the regime there and for the way it forced the expulsion of the inspectors. And so it might be that there will come a time when a good case could be made for an attack against Iraq. I am led to believe by my reading between the lines that this Administration is considering an attack as one of the options. It hasn't been reduced to a full plan yet, nor has it been reduced to a "recommendation on the President's desk." But apparently this is being discussed.

There have been some statements, I think, that have not been overly carefully worded in meetings with the Administration with respect to Iraq and Iran and North Korea. When you talk about Iraq, especially, and North Korea, we are talking about huge land forces. This would be a major undertaking, I am sure, if we ever start down that road.

What I am saying is I hope that this Administration will keep in mind that there is still a Constitution around these days, and I hope that this institution here, we in the Congress, both Houses, will keep in mind that there is still a Constitution. Anyway, we all want to join with the President and his desire to seize these terrorists and to bring them to justice. We join with him in that. But words do matter. Words do have consequences.

I notice that the expression concerning the "axis of evil" resulted in Iran in huge crowds in the millions going into the streets yesterday to protest the use of these words. And whereas there seemed to have been a moderate group in Iran that was beginning to emerge, I would hope we would be careful in what we say. I think we Senators have to be careful, too. That goes with the territory.

But when it comes to attacking any one of these states, I would hope the Administration would be prepared to make this case to the Congress and to the American people and to keep in mind the eighth section of Article I of the United States Constitution which gives Congress the power to declare war, to raise and support armies, to provide and maintain a Navy, because without the support of the people behind a venture of that dimension, the President would soon find himself on pretty thin ice. We found out about that in the Vietnam War. The President did not have the support of the people for the prolonged effort that that was becoming, and we saw what happened.

I hope that this Administration—and you are part of it, and you would have a big voice in it, and your voice will be needed, too. And I hope that this Administration keeps in mind that it cannot go it alone. If it starts down that road, actually, of a war with a State, a sovereign state, it will need the support of the Congress. And it will need it at takeoff as well as on the landing. And the American people have to be behind it, and the way to have the American people behind it is to come forth to the American people and make the case and ask the Congress for a declaration of war. And I maybe will vote for that if a case can be made for it. I may not. But I am thinking, one, there is a country here or there that I might do that at a given time. But it is certainly needed that Congress cannot be just a silent partner that is consulted. The Constitution doesn't say anything about "consultation."

So take that, think about it, if you will, and as you are within the high councils of the Administration and pondering these deep matters, consider the fact that there are some people up on the Hill who have been elected by the people, and there is a Constitution.

And what would you think? Do you think if we venture into a situation like that the Administration should have a declaration of war? I am talking about an attack on any one of these "three evil states."

Mr. WOLFOWITZ. Senator, I am in the medium-level councils, and I take very seriously everything you have said. I think we are talking about the gravest possible issues, and they are deep constitutional issues.

I would point out—and you have already said it—there is a bit too much loose talk on the subject. I don't want to add any embellishments of my own. I think what the President did do was to identify three countries that pose serious problems for us because of the nature of their policies and the capabilities they possess. And I think it gives an opportunity—I have said this to some of our allies, who say as though he went from that to immediately deciding what to do, I think it is an opportunity for a debate, for registering the kind of fundamental points that you have just registered. I don't think he meant it all, but because they share those common characteristics that, therefore, you have the same policy for all three of them. I don't think he has drawn conclusions on any of them about exactly what to do. But I think we would all agree that countries that are hostile to us and that are developing weapons capable of killing hundreds of thousands of people are a serious problem, and that it seemed a bit theoretical before September 11th. It is not theoretical at all, anymore, and I think that is the important point.

Senator BYRD. But let's all keep in mind that diplomacy, diplomacy, diplomacy, might and patience, along with preparations, might save us from having to use the weapons of war.

I thank you, Secretary. Thank you, Mr. Chairman.

Mr. WOLFOWITZ. Thank you, Senator Byrd.

Chairman CONRAD. Thank you. And I would say to the Senator, West Virginia always has wise advice.

Let me just say this to you: We are together. And no adversary should doubt that Congress stands shoulder to shoulder with the President and this Administration on this question of combating terrorism. And I hope it is very, very clear that we are going to provide the resources necessary to defend this Nation.

At the same time, we have got an obligation and you have an obligation, the Administration has an obligation to use the funds entrusted to us carefully. And when I look at the out-year effect of the President's request, as we look at it, the is asking for, when inflation is considered, the largest amount of money in the year 2012 for defense that we have had in any year in 50 years, with the exception of 1985. That is a lot of money.

I think we are going to have to as a body look very carefully at the long-term impact of what is being recommended. But I want to make it very clear to anyone who is listening that we are going to stand very clearly with this President and this Administration in prosecuting this war against terror. Let there be no doubt that the resources to defend this Nation are going to be provided by this Congress and certainly by this Committee.

Again, we thank you——

Senator BYRD. Mr. Chairman, would the Chairman allow me just a postscript?

Chairman CONRAD. Certainly. I just would alert the Senator that we are now down to seven and a half minutes on a vote.

Senator BYRD. OK. I thank you.

Let me also join the Chairman in reassuring the Secretary, I hope I didn't say anything that would leave any doubt as to where I stand. I have pretty good credentials when it comes to supporting the defense of this country. I was fighting communism a long time ago, 50 years ago, when I came here, when I started. I was very opposed to the entry of Red China into the United Nations. I supported Mr. Johnson in the war in Vietnam. I was practically the last man out of Vietnam. I offered an amendment in the Senate to express support for President Nixon in his attacks on the Viet Cong enclaves in Cambodia that were allowing men to slip across the border of South Vietnam to kill Americans. And I offered an amendment which my own majority leader—I was the Democratic whip at that time. I offered an amendment which my own then-majority leader, Mr. Mansfield, for whom I have great respect for his patriotism, opposed. But I offered it, saying that the President has a duty to do whatever it takes to get our boys back home, to keep them safe. I lost on the amendment because I was—I couldn't beat my own majority leader and the others, Frank Church and so on.

So I have a good record of support. I have been on the Appropriations Committee now for 50 years, too. And I think I voted for almost every weapons system that ever came down the pike. I have been on the Armed Services Committee with Senator Russell and Senator Stennis when they were chairmen. So I have good credentials on that.

But I tell you one thing else. I am alarmed by, I am concerned about some of the things that are being said and the words that are being used by this Administration in so high places. And I just want the Administration to just—I just want to call its attention to the fact that there is a Constitution and that unless the American people through their elected representatives are in the takeoff, no President can sustain a prolonged conflict if the American people go sour. These are the things I am asking.

Mr. WOLFOWITZ. I appreciate it, Senator. You have a long memory. I think you have known some of the people who have underestimated the will of this country in the past. One of my favorite quotes is one from Churchill's memoirs where he describes his feelings on December 7th or December 8th, right after the attack on Pearl Harbor, and he says, "I can't conceal the fact I was overjoyed at this" because it meant the United States was in the war. And he said it reminded him of what Earl Grey, the British Foreign Minister at the time the Americans entered World War I, had said to him. He said, "The United States is like a gigantic boiler, and once you get the fire lighted, there is no estimating the power it can generate."

I think these terrorists will be added to the list of people who underestimated the strength and will of this country, and it comes from our Constitution and this constitutional system. And we will work with you in strengthening it. Thank you.

Senator BYRD. Thank you. Thank you, Mr. Chairman, for your kindness and courtesies to me.

Chairman CONRAD. Well, thank you for your wise words, and I thank both the witnesses. I apologize. We are little beyond the time that we had agreed to. I hope it doesn't inconvenience you too much. There are just a few minutes left in this vote, so we will close the hearing.

Mr. WOLFOWITZ. I will tell Secretary Rumsfeld it is all your fault, Senator.

Chairman CONRAD. Thank you.

[Whereupon, at 12:41 p.m., the committee was adjourned.]

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

No Senator needs to be reminded that this Nation is at war with terrorism, and no Senator needs to be told that to win this war we must give the men and women in the Armed forces every form of support we can.

I say "no Senator" needs to be reminded of these things because everything I have heard from both Republicans and Democrats in Congress tells me that there is virtually unanimous support for the President's National Defense budget request.

What President Bush has requested for the Department of Defense matches what Ronald Reagan received at the height of the Cold War. Then, we had a super-power opponent, the Soviet Union. Today, no sovereign nation s defense budget even begins to match the United States, and our defense budget exceeds that of just about every major regional power in the world today. . .combined. Moreover, our Armed Forces are now just about half of what they were during the Reagan administration, and we can spread that same amount of money over a smaller force.

These are the arguments that we used to hear when someone wanted to reduce spending for the Armed Forces. Those arguments are now overtaken by the events of September 11. We rarely hear them any more, and when we do, they sound out of place.

The current circumstances—a very large defense budget and overwhelming bipartisan support for it—might make observers think this hearing will be a "love-in" with the representatives we have here from the Defense Department.

I support the President's National Defense budget, but I also believe there are some issues that this Committee must address. In my judgement, those issues are the following:

First, large as it is, is this defense budget large enough? Various defense analysts have identified areas where this budget provides disturbingly low levels of support. These areas include naval ship building, Navy flight hours, training and depot maintenance across all the military services, the "Science and Technology" and Military Construction budgets, and the Defense Activities of the Department of Energy.

Second, are there areas in this defense budget that may or may not be getting too much money? The President has requested an emergency $10 billion fund fight the war on terrorism, but the budget materials did not tell us where, when, and how the funds will needed. I am sure whatever the President needs to fight this war Congress will provide—and, at the time of the emergency, $10 billion may not be enough—but as an emergency must it be provided at this time? Should we attempt to pay for unknown military operations now or only when we all know and can support the President's decision?

Third, do the priorities need to be adjusted? Some have suggested that this budget fails to "skip a generation" of weapons to enable a "transformation" to prepare for the Twenty-first century, as the President promised. Some suggest there remain conceptually obsolete weapons in the budget, such as the Army's "Crusader" artillery system that are designed to fight the last war, not the next one. Can those funds be better used elsewhere? These are criticisms that have to be considered.

We have also heard some ideas I believe we must immediately reject: some have suggested that now that we have fully funded the Defense Health Program, we should raid it for funds for other programs.

Thus, at a time of strong bipartisan support for the increases that the President has requested for the National Defense budget, there are some difficult issues that this Congress and this Committee must consider.

To help us do that it is a pleasure to be able to hear two of the prime architects of this budget. Thank you for being with us today, Deputy Secretary Wolfowitz and Under Secretary Zakheim. I look forward to hearing your analysis of the issues before us.

PREPARED STATEMENT OF SENATOR RUSSELL D. FEINGOLD

Mr. Chairman, thank you. The world is a very different place than it was when we met last July to discuss the President's fiscal year 2002 request for defense.

That request included a $26 billion increase that the Administration said was necessary to begin a new military transformation that would modernize our Armed Forces for the new challenges of the 21st century.

Those challenges were deadlier than any of us could have imagined. The events of September 11 galvanized our countray and our allies in a global fight against terrorism and those who would shelter, support, and finance those who carried out these acts. There can be no doubt that Congress should provide the resources necessary to fight and win this war. There should also be no doubt that this war should not be used as an excuse to drastically increase an already bloated defense budget.

Mr. Chairman, I commend our men and women in uniform for their tireless efforts to find those responsible for these crimes. But as laudable as it might be for the United States to root out all bad actors around the globe, such action would be both outside the scope of the use-of-force resoulution that Congress passed, and beyond our financial means.

This time of previously unimaginable challenges to our country demands that we scrutinize carefully how we spend our scare resources.

The budget request includes a $48 billion increase for the Department of Defense—to $379 billion. And there is an additional $17 billion for defense-related programs at the Department of Energy and at other Federal agencies, for a grand total of a $396 billion for defense activities for next year.

Just how big is this budget request?

This would be the largest one-year increase in defense spending since the height of the Cold War.

This request is 15 percent higher than the average Cold War budget.

It is three times the defense budgets of Iran, Iraq, Libya, North Korea, Cuba, Sudan, and Syria combined.

It exceeds the Gross Domestic Product—the whole economy—of two-thirds of the countries of the world, including Cuba, Israel, Kuwait, Lebanon, North Korea, Saudi Arabia, Pakistan, and Vietnam.

And the Administration projects that the budget request for defense would grow to $451 billion by fiscal year 2007.

Mr. Chairman, we should not allow fiscal responsibility and congressional oversight of the President's budget request to fall by the wayside as fight the war on terrorism. A strong national economy is also importatn to our national security. The war on terrorism does not require Congress to abdicate its responsibility to review closely the funding requests of the President, and it does not prohibit discussions about the direction of Federal spending, including defense spending.

As we begin the discussion of the fiscal year 2003 defense budget, I would like to outline some of my priorities. We should ensure that our National Guard and Reserves, more than 75,000 of whom have been called to active duty as part of Operation Noble Eagle or Operation Enduring Freedom, are adequately compensated for their service and sacrifice. These men and women are one of the cornerstones of our Armed Forces, and we should ensure that they have adequate pay and benefits.

Congress should carefully scrutinize the procurement budget and take a hard look at the utility of continuing to fund Cold War-era weapons systems. We should work to ensure that no weapons systems enters full production before it has been fully test to ensure that it will perform its intended mission in a safe and cost-effective manner and that it does not duplicate the mission of existing weapons systems. We should not spend taxpayer dollars on "next generation" weapons systems that are not significantly better than existing systems.

And we should work with the Department of Defense to make sure that Congeress and the American people get an accurate accounting of how defense budget is being spent. Secretary Rumsfeld told the Armed Services Committee last week that his Senior Executive Council is studying ways to run the Department more efficiently. Time and again we hear about duplication of effort, antiquated accounting practices, and mismanagement at the Pentagon. I am deeply troubled that millions of taxpayer dollars continue to go unaccounted for each year.

A report issued last year by the Business Executives for National Security's Tail to Tooth Commission outlines in detail the myriad accounting and inefficience problems at the Pentagon and offers recommendations onhow these problems could be addressed. While each of usmamy not agree with all of their recommendations, we can all agree that this problem needs to be addressed.

I urge the Department to do more ensure that this situation is rectified. It is possible that the $48 billion increase that they seek for next year—and then some—may already exist within the current the Pentagon budget.

Thank you. Mr. Chairman.

THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSAL

THURSDAY, FEBRUARY 14, 2002

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, Wyden, Byrd, Nelson, Stabenow, Corzine, Grassley, Bond, Gregg, Snowe, Frist, and Smith.

Staff present: Mary Ann Naylor, staff director; Sue Nelson, deputy director; and Jennifer Cantrell, javits fellow.

For the minority: G. William Hoagland, staff director; and Kathleen Weldon, senior policy analyst for health.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order. I want to begin by welcoming our witness, Secretary Tommy Thompson, for a return visit to this committee. Welcome, Mr. Secretary. As the Secretary of Health and Human Services, you manage over 300 separate programs and the largest budget of any Cabinet agency, about $460 billion a year.

Let me just say that, as I continue to examine the budget that the Administration has sent us, I believe it simply does not add up, that it plunges us back into deficits not only this year and next year, but for the entire next decade. As this chart indicates, if we set aside the trust funds of Medicare and Social Security, there is red ink as far as the eye can see.

In addition—let's go to the next chart—it breaks the promise that was made by the President and made by virtually everyone in elected office not to invade the trust funds of Social Security and Medicare.

Last year, we were told there were non-trust fund surpluses of $2.7 trillion over the next decade. Now we see, instead of surpluses, $2.2 trillion of deficits in the non-trust fund accounts. That means the trust funds will have over $2 trillion taken from them to pay for tax cuts and other expenses of the Government.

Last night, as I examined the budget submission of your agency, I came to the conclusion that somebody in the Administration has cooked the books and cooked them big time with respect to Medicare. The Congressional Budget Office says this budget understates the costs of Medicare by $300 billion over the next decade.

The New York Times wrote, and I quote, “Assuming a slower growth rate for Medicare has the same effect as cutting the Medicare budget. It saves money. But it avoids the political uproar that would surround a proposal for large cuts in Medicare.”

Mr. Secretary, I direct your attention to this chart that shows the difference between what others are saying will be the increase in medical costs over the next decade and what this budget is saying.

The private health insurance spending per capita estimate for 2003 to 2010 says health care costs will increase at 6.1 percent. The CBO Medicare estimate is for 5 percent growth. The OMB, the Office of Management and Budget, Medicare estimate is for 3.5 percent growth. Medical inflation in 2001 was 4.7 percent. I believe the folks over at OMB have cooked the books to make this budget look like it adds up better than it really does.

Mr. Secretary, I doubt very much these are your numbers. I have got strong respect for you and the job you have done especially since the very difficult events of September 11th and the pressure that that has put you and your agency under. I think you have conducted yourself admirably and I think, as I have said many times from this podium, that the President and this Administration has conducted themselves in the best American tradition in responding to the attack on the country.

But I don’t have that feeling about the budget that has been submitted by the Administration. As I look ahead, I think it is putting us in a position for the future in which a future Congress and a future President is going to face excruciating choices.

The Director of the Budget Office, Mr. Crippen, has come before this committee and said that we were going to face either massive cuts in benefits, huge tax increases, or massive debt because of the retirement of the baby-boom generation. And the budget that this President has set up here doesn’t deal with it at all. In fact, it abandons the fiscal discipline that virtually all had agreed to—that we would save the Social Security Trust Fund moneys for the purposes intended, not use them for other purposes.

And once you go through that line in the sand, there is nothing that stops those who want more tax cuts and more spending, and I can tell you, after meeting with colleagues, the flood gates are wide open. They are wide open. Every tax-cutting scheme, every spending idea is being promoted, and being promoted with vigor, because once you cross the line on the question of Social Security, there is no line. There is no line. And that is what I am finding.

I tell you, the consequences for this country are enormous, and what people don’t seem to get is that we are in a fundamentally different circumstance than we have ever faced before. This is a demographic time bomb. We have never faced anything like this before in our history. And we ought to be getting ready for it, and that means we ought to be saving Social Security and Medicare surpluses, use that as a line in the sand, and on top of that, we ought to do more because saving the trust fund moneys is necessary but not sufficient.

But I tell you something, there is very little stomach for what needs to be done here. And because the President sent up a budget that doesn’t seem to care, nobody else does either. I can tell you, colleague after colleague tells me, well, the President has crossed the line; it doesn't matter to him if we use Social Security money; so let's all get in on the party.

I don't know how this is—you know, here we are, somebody told me this is like the 1980's. Oh, no, this isn't like the 1980's. This is much worse than the 1980's. In the 1980's there was time to recover. We had 20 years before the baby-boomers started to retire. There is no time to recover this time. These fiscal mistakes are really going to come home. The chickens are going to come home to roost.

So, Mr. Secretary, you know, I am expressing myself this morning. You are here. I don't think you are really the one that is the culprit here. In fact, I know you are not. But as we start to write a budget resolution here, I really am worried about the attitude I am finding. And it starts right at the top with the President of the United States. He sent us a budget. It doesn't come close to adding up. It isn't in hailing distance of adding up. And that has encouraged everybody else to abandon the fiscal discipline that we had all agreed to put in place. That is what I am finding. And I am having meetings with individual members every day. It isn't pretty, what I am finding.

With that, I will turn it over to our colleague and indicate that Senator Domenici is again not with us today. He is, as you know, recovering from ill health, and we miss him, and we hope for his swift recovery. And we very much hope he will be back with us soon.

Filling in very ably for him is Senator Frist from Tennessee. Perhaps others don't know this, but Senator Frist sends us all, Members of the Senate, a letter on our personal health every year. I tell you, that letter is on the refrigerator in my house, and he is our doctor, in essence, the only medical doctor in the Senate. So he is not only Tennessee's doctor, he is the Nation's doctor.

Senator FRIST. Mr. Chairman, there are ten things on that list, do all ten of them. It doesn't matter if it is sitting on the refrigerator. You got to do those ten things.

Chairman CONRAD. That is right.

Senator FRIST. You don't have to answer yet. Let's see how the hearing goes.

Chairman CONRAD. Let me just tell you, on one matter, the matter of a proctoscopic, the colonoscopy, Senator Dorgan went to the Capitol physician, and it was recommended that he have one, and he immediately said, "Has Senator Conrad had his?" And he told him, "You schedule me right after you schedule Senator Conrad." [Laughter.]

Senator FRIST. It is a good test, and not as bad as people think.

Thank you, Mr. Chairman. And I will—— [Laughter.]

Senator FRIST. Did you have yours this morning? Is that what it is?

Chairman CONRAD. No. I read the budget. It was even worse.

Senator FRIST. Thank you, Mr. Chairman.

I do ask unanimous consent that we enter Senator Domenici's opening statement into the record.

Chairman CONRAD. Absolutely.

[The prepared statement of Senator Domenici follows:]

THE PREPARED STATEMENT OF SENATOR PETE V. DOMENICI

- Good morning, Secretary Thompson. Thank you for joining us this morning.
- We are here today to discuss the fiscal year 2003 budget for the Department of Health and Human Services, the second largest department in the Federal Government (after the Social Security Administration) with a proposed budget of $492 billion.
- Your budget is larger even than the Pentagon's proposed budget of $379 bililion for next year.
- Your Department plays a vital role in promoting the health and security of our citizens through a vast range of programs and services.
- Over the last few months, you have taken the lead in the fight against bioterrorism. The President has proposed $5.9 billion in spending to fight bioterrorist attacks, and more $4.3 billion of this goes through the various agencies of your Department, including the Centers for Disease Control, the National Institutes of Health, and the Food and Drug Administration.
- But in addition to protecting the Nation from extraordinary threats, the HHS budget provides vital basic services to promote the health and welfare of some of our most vulnerable citizens.
- For example, the President's initiative to increase the number of Community Health Centers will provide direct healthcare services to millions of the uninsured.
- And the budget makes great strides toward reducing the number of uninsuired by proposing health insurance tax credits that will help up to 6 million people acquire health insurance.
- We are all aware, Mr. Secretary, of the primary role that you played as Governor of Wisconsin in shaping the 1996 welfare reform legislation. This landmark legislation has reduced welfare caseloads by more than 50 percent and also led to higher incomes and lower poverty rates for many recipients.
- I am pleased the President has continued his support for welfare reform and also for the supplemental grants that aid poor States like New Mexico. But, I am hoping that today you might elaborate on the Administration's plan to address the last remaining task of welfare reform: encouraging the formation and maintenance of two-parent families.
- Finally, one of the top issues that will face this Congress will be providing a prescription drug benefit for Medicare. The President has allocated $190 billion over 10 years for Medicare reforms, and has taken a sensible first step to increasing prescription drug coverage by proposing a drug subsidy for low-income seniors.
- We may differ on the amount of money that needs to be allocated to Medicare, but I think that we can all agree that we need to address both the fiscal challenges the program faces and the gaps in its benefits package. And these issues need to be addressed together—it would be irresponsible of us to enact a new universal drug benefit without also taking steps to reform Medicare to make it solvent for future generations.
- Secretary Thompson, thank you for joining us here today. I look forward to hearing your testimony.

OPENING STATEMENT OF SENATOR FRIST

Senator FRIST. Mr. Chairman, thank you for holding this hearing. I am going to focus a little bit more on the issue at hand. The opening statement just made was on the big issues, but I do want to focus on the issues that will affect every single American alive today, will affect our seniors, will affect all of us in this room, and will affect future generations in ways that you can see in the budget, but in many ways you can't see directly. Things like research and development investment create the potential of cures for everything from cancer to heart disease to HIV/AIDS. We also need to look at the uninsured, which is a problem that has increased dramatically over the last 7 to 8 years that I have been here.

Well over $400 billion, the budget of Health and Human Services accounts for a significant proportion of the overall budget, second only, as the Chairman mentioned, to the Social Security Administration.

It includes Medicare, the program for individuals with disabilities and our seniors, Medicaid, Assistance for Needy Families, the Ryan White Act, which addresses the HIV issues, health centers, the National Health Service Corps, and the tremendous investments in our National Institutes of Health. Doubling funds at NIH, a commitment of the President, will encourage many people who are listening now, who have spouses, loved ones, parents and grandparents with illnesses, looking for that cure that we are always reaching out for.

Secretary Thompson, over the last 2 days, you and I have seen each other many times; we have been at many hearings. Yesterday testified before Foreign Affairs on the issue of HIV/AIDS internationally. I each time have seen you, you have mentioned organ transplantation. I just want to say thank you on behalf of all of us in the United States Senate for your personal commitment and service.

These are difficult economic times. There is a clear need for this Nation to devote resources to the emergency, to the war itself, and to what we can do in terms of stimulating the economy and creation of jobs as we go forward, given the fact that we have been in a recession.

Amidst all of these priorities which have been so radically defined or redefined in recent months, I am delighted to see significant investments in the pressing domestic priorities which are outlined in the budget.

The doubling of funding at the NIH to over $27 billion is something that 5 or 6 years ago I would have said, Impossible. There is no way when I first came to the United States Senate that I thought we'd see that sort of investment, and because of the work of this Committee and the leadership now of you and President Bush, it is a reality that will help us fight the sort of diseases of heart and lung and other types of diseases, but also will translate into the future cures for the incurable diseases of today: HIV/AIDS, 40 million people, 27 million people dead. There is no cure, there is no treatment. Opening up the possibility of reversing the greatest pandemic that this world has ever seen.

Our public health system, again, true strengthening in this budget. That public health system which for the last 15 or 20 years has simply been neglected.

I mentioned the uninsured, 40 million Americans without insurance today. When you look at what the Administration proposes in terms of the medical savings accounts, National Health Service Corps, community health centers, Medicaid, caregiver assistance, the State Children's Health Insurance Program, all of these work in a direction to make health care more affordable.

Medicare, and, again, as we look at slides in terms of projections over the next 5 years or 10 years, it's useful to do, and that's what budgeting is all about, and it's critical. But it drives home to me, as a physician, as someone who has been responsible for some of that, when I do a heart transplant, it is very expensive, but it is also life-saving. When I prescribe thousands of prescription drugs, which I have done, it is very expensive. And then you look at the figures and the projections, which I agree with in terms of the projections, it shows that we have got to engage in, again, what you and the President have been leaders on and have stayed out there on, and that is comprehensive modernization of Medicare, which recognizes that we have to do something which doesn't just make us feel good, like add prescription drugs, but we have to do it in a sustainable way as we project ahead. And we are not going to be able to accept costs of increases in prescription drugs of 20 percent year after year after year, or even some of the figures that have been presented earlier. So we really do need to have comprehensive Medicare reform.

Prescription drugs is an issue that must, I believe, be address as part of that comprehensive Medicare reform, but an issue that we have to address head on today. I am sure we will come back and talk about the progress and the importance of having prescription drugs as part of that overall plan.

Let me just briefly show again—because the President as on a regular basis outlined this agenda, but it gives a large framework, not of the overall budget but of where we are going as we budget for the future. President Bush's agenda for improving health security, providing Medicare prescription benefits for seniors and individuals with disabilities. Again, it is not there today. I believe it has to be there as part of overall Medicare reform.

Strengthening Medicaid, S–CHIP, and the health care safety net, the President spoke to that just last week. Expanding biomedical research, which I mentioned, and expanding affordable—really, this whole affordable health care, how we address that both in Medicare and Medicaid and in the uninsured. Specific proposals have been on the table for medical savings accounts, for health credit, and for association in the health plans.

Let me just close with bioterrorism because it is an issue that received a fair amount of press, but it does show the challenge that we have as we look at the budget itself. Bioterrorism, we didn't think very much about it. We have neglected our public health infrastructure. So now as a priority, a shifting priority but a very appropriate priority, we are having to address support of our public health infrastructure, prevention, research, and response to a biological attack. We will see more biological attacks in this country, period. We need to respond to that. We need to respond today.

Increasing State and local capacity, research and development, fortifying Federal response capabilities, improving communications and surveillance, and I will close just with the last slide because it does show the response of this Administration.

This is from 1998 to 2003. The yellow is the proposed budget for bioterrorism preparedness. This has been put on the table. I support it 100 percent, and I think it is something that will have to be sustained over time. Again, I appreciate the Administration recognizing that in the past we have inadequately invested, that a new investment is going to be required today, and as part of that, we have to look at new priorities just like we have to look at Medicare and strengthening Medicare in a new way, a new paradigm so that we can modernize Medicare and include prescription drugs.

Mr. Secretary, thank you for being with us today, for testifying today. Thank you for your leadership in strengthening our public health system and our acute and chronic medical health care system.

Chairman CONRAD. Thank you, Senator Frist.

Mr. Secretary, why don't you proceed with your statement? The typical procedure for this Committee is, after you have concluded, we will go to questioning rounds. Each Senator will have 7 minutes for a statement or questions or however they choose to use the time.

Please proceed.

STATEMENT OF HON. TOMMY G. THOMPSON, SECRETARY, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary THOMPSON. Thank you so very much, Chairman Conrad, and thank you for your very kind words. I appreciate that very much. I was a little bit concerned that you would not be here this morning because I know of your love for baseball. I thought since it was the opening day that you might attend one of those spring camps. But I am very appreciative that you are here, my friend.

Chairman CONRAD. I am headed there tomorrow. [Laughter.]

Secretary THOMPSON. Senator Frist, thank you so very much for your leadership. I appreciate it very much, and thank you for your counsel and your assistance, and all the members of this Committee, thank you so very much for giving me this opportunity.

Please express my appreciation to Senator Domenici, and I wish him well. I called him and was hoping he would be here, but I know he is recovering and I wish him well.

As I begin this morning, Senators, let me mention that today is National Donor Day. Encouraging a donation is a priority of my work. It is one of my passions. As Secretary of Health and Human Services last year, we launched the national Gift of Life Donation Initiative to encourage Americans to donate organs and tissues and to make it easier for them to do so.

I hope all Members of Congress have signed donor cards. I also hope that you will wear the donor pins that you have been given to show your support.

Organ donation saves and transforms lives. We can all join in this wonderful effort, and I thank all of you for supporting this very important endeavor.

And let me thank you for your commitment to this issue, Senator Frist. I understand that you introduced legislation on donation yesterday with Senator Dodd. I look forward to working with you on this important issue, and hopefully we can get it passed this year.

President Bush has identified several critical priorities for America at this time in our history. They include winning our war on terrorism, defending the homeland, creating jobs, and securing a healthy future for everyone in this country. As he said earlier this week in my home State of Wisconsin, "The role of Government in health reform is to fix the system where it is failing, while preserving the quality and innovation of a private, patient-centered medical system. All reform should be guided by some goals." The President's HHS budget goes a long way toward meeting that standard.

The HHS budget furthers the work of preparing America for bioterrorism, as Senator Frist has said. In total, we are calling for

$4.3 billion—an increase of 45 percent over the current fiscal year, and I know this is something Senator Gregg has led the effort on many times as well, and I applaud him for it. This effort is to support a variety of critical activities to prevent, identify, and respond to incidents of bioterrorism. We are building up our national pharmaceutical stockpile, increasing assistance to State and local governments, preparing the Nation's hospitals, and doing more to protect America's food supply, something that, Senator Conrad, you have taken the lead on, and I applaud you.

In the President's budget, we have reduced the number of HHS personnel offices from 46 to 4. We are realigning and consolidating throughout the Department. We are able to save the equivalent of 705 full-time positions. And we have launched a regulatory reform initiative to reduce the paperwork burden on physicians and hospitals.

Our budget meets the President's commitment also of doubling funding for the National Institutes of Health by 2003. It provides the support for childhood development while delivering responsible management of HHS resources. And we provide $20 million for our new Healthy Communities Initiative, which will concentrate Department-wide expertise on the prevention of diabetes, asthma, and obesity. Our plan confronts the challenges of today as well as tomorrow while enhancing the health of ever citizen of our great country.

Mr. Chairman, as you have mentioned, the total HHS request for fiscal year 2003 is $489 billion in outlays, an increase of $29.2 billion, or 6.3 percent over the comparable fiscal year 2002 budget. The discretionary component of our budget totals $64 billion in budget authority, an increase of $2.4 billion, or 3.9 percent.

There is much that could occupy my oral comments, but let me highlight three areas of special concern to this Committee: specifically, the President's plan to continue extending coverage to the uninsured, strengthening and modernizing Medicare, and taking our successful efforts in reforming welfare to the next level.

Before I discuss those issues, let me briefly discuss something I know is of great concern to you, Mr. Chairman: Medicare reimbursement in rural areas. I come from the city of Elroy, Wisconsin, population of 1,500. Rural health is of personal concern to me. When hospitals and other providers struggle to survive in a rural community because Medicare payments systems fail to reflect local conditions, people suffer. It is not the providers' fault.

We have monitored this problem, and we are committed to working with you, Senator Conrad, and with Congress to see that it is resolved. This is a statutory matter that must be addressed by legislation. I wish I could tell you here that we have an immediate answer to this problem. I can't. But I can tell you that I will work with you to address this matter fairly and effectively.

Let me now discuss our initiatives to help the uninsured. There are about 40 million Americans who lack health insurance. That is simply too many in a Nation as compassionate and as well-off as America.

That is why during the first year of the Bush Administration, we have made great strides in extending access to health care to Americans. For example, since January of this year, we have approved State plan amendments and Medicaid and S–CHIP waivers that have expanded opportunity for health coverage to 1.8 million Americans and improved the existing benefits to 4.5 million individuals.

But we must do more for those who need help the most—working American families that lack access to quality health care. So in this budget, we increase access to quality health care for all Americans.

The President's outreach includes a significant investment in community health centers, which provide quality, family oriented, preventive, and primary health care to over 11 million patients annually, regardless of people's ability to pay Senator Bond has taken a leadership role in this area, and I compliment him. Currently, we have 3,300 community health centers nationwide. This budget seeks $1.5 billion to support the President's plan to impact 1,200 communities with new or expanded health centers by 2006. This is a $114 million increase over fiscal year 2002 and would support 170 new and expanded health community centers and provide services to 1 million additional patients. The President's long-term plan is to double the capacity of our community health center system, expanding access to care for an additional 6 million individuals by 2006.

In addition, the President has proposed providing $89 billion in new health credits to help families lacking other insurance. This plan would help an estimated 6 million Americans get health insurance, and it includes some very important changes from last year. We listened to the concerns of this Committee and Congress in general. So, for example, the President's plan increases the maximum credit to $3,000 for families with children and provides the credits up-front so families can meet monthly premiums.

Medicaid and S–CHIP provides benefits to low-income Americans, primarily children, pregnant women, the elderly, and those with disabilities. The HHS budget proposal strengthens S–CHIP by allowing the States to use an estimated $3.2 billion in unused funds that otherwise would return to the Federal treasury. These additional matching funds will enable all States to expand coverage to the uninsured, in addition to the more than 4 million children covered under S–CHIP today.

We are pursuing innovative ideas for providing health coverage to families, tackling the issue of the uninsured from multiple angles. Our plan builds upon the principles established last year by the President for modernizing Medicare. It employs some of the best ideas of Republicans and Democrats, including ideas developed in this Committee. It takes advantage of what both Government and the private sector have to offer.

Helping meet the health needs of the uninsured is part of our larger effort to strengthen the entire health care system. Modernizing Medicare is another key component of this effort. Since becoming Secretary, I have begun to modernize the very structure of the Centers for Medicare and Medicaid Services. Reforms have occurred, and there are a lot more to come.

These reforms are essential to the continued success of the Medicare program, which is why this budget is such a significant step forward. It dedicates $190 billion over 10 years for immediate targeted improvements and comprehensive Medicare modernization, including a subsidized prescription drug benefit and better insurance protection and private options for all beneficiaries.

This budget also proposes a subsidized drug benefit as part of modernized Medicare, but also providing better coverage for preventative care and serious illness. We also propose that preventive benefits have zero co-insurance and be excluded from the deductible. We must make these improvements to more effectively address the health needs of seniors today and in the future. For years, we have debated Medicare reform in this Committee and in Congress in general as an all-or-nothing proposition that has only so far produced failure. We have to act, and the President's plan, I believe, shows us the way.

This year, HHS will continue working to implement the President's proposed Medicare-endorsed prescription drug card. The card will give beneficiaries immediate access to manufacturer discounts on their medicines and other pharmacy services.

Assistance, however, will not come only through the prescription drug card program. The budget proposes several new initiatives to improve Medicare's benefits and address cost, and offers additional Federal assistance for comprehensive drug coverage to low-income Medicare beneficiary up to 150 percent of poverty, about $17,000 for a family of two.

This policy helps to establish the framework necessary for a Medicare prescription drug benefit and is essentially a provision that is in all of the major drug benefit proposals before Congress.

Recently, I announced also a model drug waiver program called Pharmacy Plus to allow States to reduce drug expenditures for seniors and certain individuals with disabilities with family incomes up to 200 percent of the Federal poverty level. This program is being done administratively. In Illinois, the waiver we approved about 2 weeks ago will give an estimated 370,000 low-income seniors new drug coverage. The Illinois initiative illustrates how we can expand coverage to Medicare beneficiaries in partnership with the Federal Government.

So we are moving forward with strengthening Medicare. But just as Medicare needs renewal, so welfare reform must be ongoing as well. As you know, welfare reform is one of my great passions. In Wisconsin, we devoted substantial resources to helping people get the training, health insurance, child care, and other services they needed to go from welfare to work.

Welfare reform has exceeded expectations, resulting in millions moving from dependence on AFDC to the independence of work. Nearly 7 million fewer individuals are on welfare today than in 1996, and 2.8 million fewer children are in poverty due to welfare reform.

But we are not done. There is a clear and important next step to welfare reform. This budget boldly takes that next step, which requires us to work with States to help those families that have left welfare to climb the job ladder and become more secure in the work force. And while doing so, we must not leave behind those still on our caseloads.

But, ultimately, welfare reform is not about numbers on a chart. It is about restoring hope and dignity to human lives. It is about restoring the promise of the American dream to people trapped in dependency. And as President Bush has said, we are committed to leaving "no child behind."

Our budget takes those goals seriously. It allocates $16.5 billion for block grant funding, provides supplemental grants to address historical disparities in welfare spending among States, and strengthens work participation requirements. The budget provides $100 million in broad demonstration authority focused primarily on encouraging healthier families. In addition, we will be submitting a proposal to create a matching State grant program to strengthen families and reduce out-of-wedlock births.

While this represents level funding for TANF, it provides the funds that States can spend on helping workers remain in the work force. States will be able to apply the savings gained from caseload reduction to new programs that help workers thrive in the work force. We are giving States the flexibility they need to mix effective education and job training programs with work, and we are providing States money to strengthen families and reduce illegitimacy.

We hope to work with you in Congress to more specifically shape the next step in welfare reform. In doing so, however, we cannot get away from the foundation of welfare reform's success—work. Work must remain at the core of TANF, for work is the only way to climb out of poverty and become self-sufficient. We must continue to help working families remain employed and advance their jobs by providing the proper child and health care programs.

President Bush's budget helps by providing an additional $350 million in Medicaid benefits for those in the transition from welfare to work.

The budget request includes an additional $130 million for the promoting safe and stable families program bringing it up to its auth level of $505 million. These funds will move children to adoption more quickly so they can become part of safe and stable families as well as enhance preventive efforts to help families in crisis.

Mr. Chairman, the President's agenda is compassionate, financially sound, and far-reaching. The President's investment in the health security of America is tremendous given the pressing needs for the investment in national defense and homeland security. We are moving across a broad range of endeavors to provide the people of our country with affordable, accessible, and accountable health care.

Working with you and the members of this great committee, Mr. Chairman, I am confident that we can make dramatic progress in reaching that objective for every American. Thank you again, and I look forward now to your questions and our discussion.

[The prepared statement of Secretary Thompson follows:]

THE PREPARED STATEMENT OF TOMMY THOMPSON, SECRETARY, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Good Morning Chairman Conrad, Senator Domenici and members of the Committee. I am honored to appear before you today to discuss the President's fiscal year 2003 budget for the Department of Health and Human Services. I am confident that a review of the full details of our budget will demonstrate that we are proposing a balanced and responsible approach to ensuring a safe and healthy America.

The budget I present to you today fulfills the promises the President has made and proposes creative and innovative solutions for meeting the challenges that now face our Nation. Since the September 11th attacks we have dedicated much of our efforts to ensuring that the Nation is safe. HHS was the first agency to respond to the September 11th attacks on New York City, and began deploying medical assistance and support within hours of the attacks. Our swift response and the overwhelming task of providing needed health related assistance made us even more aware that there is always room for improvement. The fiscal year 2003 budget for the Department of Health and Human Services builds on President Bush's commitment to ensure the health and safety of our Nation.

The fiscal year 2003 budget places increased emphasis on protecting our Nation's citizens and ensuring safe, reliable health care for all Americans. The HHS budget also promotes scientific research, builds on our success in welfare reform, and provides support for childhood development while delivering a responsible approach for managing HHS resources. Our budget plan confronts both the challenges of today and tomorrow while protecting and supporting the well being of all Americans.

Mr. Chairman, the total HHS request for fiscal year 2003 is $488.8 billion in outlays. This is an increase of $29.2 billion, or 6.3 percent over the comparable fiscal year 2002 budget. The discretionary component of the HHS budget totals $64.0 billion in budget authority, an increase of $2.4 billion, or 3.9 percent. Let me now discuss some of the highlights of the HHS budget and how we hope to achieve our goals.

PROTECTING THE NATION AGAINST BIOTERRORISM

Mr. Chairman, as you know, the Department of Health and Human Services is the lead Federal agency in countering bioterrorism. We are responsible for preparing for, and responding to, the medical and public health needs of this Nation. The fiscal year 2003 budget for HHS is $4.3 billion, an increase of $1.3 billion, or 45 percent, above fiscal year 2002. This budget supports a variety of activities to prevent, identify, and respond to incidents of bioterrorism. These activities are administered through the Centers for Disease Control and Prevention (CDC), the National Institutes of Health (NIH), the Office of Emergency Preparedness (OEP), the Substance Abuse and Mental Health Services Administration (SAMHSA), the Health Resources and Services Administration (HRSA) and the Food and Drug Administration (FDA). The efforts of this agency will be directed by the newly established Office of Public Health Preparedness (OPHP).

In order to create a blanket of preparation against bioterrorism, the fiscal year 2003 budget provides funding to State and local organizations to improve laboratory capacity, enhance epidemiological expertise in the identification and control of diseases caused by bioterrorism, provide for better electronic communication and distance learning, and support a newly expanded focus on cooperative training between public health agencies and local hospitals. Funding for the Laboratory Response Network enhances a system of over 80 public health labs specifically developed for identifying pathogens that could be used for bioterrorism. Funding will also support the Health Alert Network, CDC's electronic communications system that provides Internet connectivity to public health departments in ninety percent of our Nations' counties. Funding will be used to support epidemiological response and outbreak control, which includes funding for the training of public health and hospital staff. This increased focus on local and state preparedness serves to provide funding where it best serves the interests of the Nation.

An important part on the war against terrorism is the need to develop vaccines and maintain a National Pharmaceutical Stockpile. The National Pharmaceutical Stockpile is purchasing enough antibiotics to be able to treat up to 20 million individuals in a year for exposure to anthrax. The Department is purchasing sufficient smallpox vaccines for all Americans. The fiscal year 2003 budget proposes $650 million for the National Pharmaceutical Stockpile and costs related to stockpiling of smallpox vaccines, and next-generation anthrax vaccines currently under development.

Another important aspect of preparedness is the response capacity of our Nations hospitals. Our fiscal year 2003 budget provides $518 million for hospital preparedness and infrastructure to enhance biological and chemical preparedness plans focused on hospitals. The fiscal year 2003 budget will provide funding to upgrade the capacity of hospitals, outpatient facilities, emergency medical services systems and poison control centers to care for victims of bioterrorism. In addition, CDC will provide support for a series of exercises to train public health and hospital workers to work together to treat and control bioterrorist outbreaks.

Today, the United States has one of the world's safest food supplies. However, since the September 11 attacks, the American people have a heightened awareness about protecting the Nation's food imports and food supply at home. The fiscal year 2003 budget supports a substantial increase in the number of safety inspections for FDA-regulated products that are imported into the country. Physical examinations of food imports will double in fiscal year 2002 over the previous year, and double again in fiscal year 2003. We anticipate further progress as new staff becomes fully productive.

Our budget also provides support for national surveillance and infectious disease detection. This includes efforts to reduce emerging infectious and foodborne diseases, improve patient safety, and provide laboratory support for HIV/AIDS, tuberculosis and immunization programs. This funding will continue to provide assistance to States and local communities to detect and prevent the spread of infectious diseases. Funds will also help prevent and control Hepatitis C, and combat antimicrobial disease strains.

The fiscal year 2003 budget also includes $184 million to construct, repair and secure facilities at the CDC. Priorities include the construction of an infectious disease/bioterrorism laboratory in Fort Collins, Colorado, and the completion of a second infectious disease laboratory, an environmental laboratory, and a communication and training facility in Atlanta. This funding will enable the CDC to handle the most highly infectious and lethal pathogens, including potential agents of bioterrorism. Within the funds requested, $12 million will be used to equip the Environmental Toxicology Lab, which provides core lab space for testing environmental samples for chemical terrorism. Funding will also be allocated to the ongoing maintenance of existing laboratories and support structures.

Investing in Biomedical Research

Advances in scientific knowledge have provided the foundation for improvements in public health and have led to enhanced health and quality of life for all Americans. Much of this can be attributed to the groundbreaking work carried on by, and funded by, the National Institutes of Health (NIH). Our fiscal year 2003 budget enhances support for a wide array of scientific research, while emphasizing and supporting research needed for the war against bioterrorism.

NIH is the largest and most distinguished biomedical research organization in the world. The research that is conducted and supported by the NIH offers the promise of breakthroughs in preventing and treating a number of diseases and contributes to fighting the war against bioterrorism. The fiscal year 2003 budget includes the final installment of $3.7 billion needed to achieve the doubling of the NIH budget. The budget includes $1.7 billion for bioterrorism research, including genomic sequencing of dangerous pathogens, development of zebra chip technology, development and procurement of an improved anthrax vaccine, and laboratory and research facilities construction and upgrades related to bioterrorism. With the commitment to bioterrorism research comes our expectation of substantial positive spin-offs for other diseases. Advancing knowledge in the arena of diagnostics, therapeutics and vaccines in general should have enormous impact on the ability to diagnose, treat, and prevent major killers-diseases such as malaria, TB, HIV/AIDS, West Nile fever, and influenza.

The fiscal year 2003 budget also provides $5.5 billion for research on cancer throughout all of NIH. Currently, one of every two men and one of every three women in the United States will develop some type of cancer over the course of their lives. New research indicates that cancer is actually more than 200 diseases, all of which require different treatment protocols. Promising cancer research is leading to major breakthroughs in treating and curing various forms of cancer. Our budget continues to expand support for these research endeavors.

Building Upon the Successes of Welfare Reform

President Bush has said that American families are the bedrock of American society and the primary source of strength and health for both individuals and Communities. Our budget includes a number of new initiatives that support this principle by targeting resources to strengthen our Nation's families. We look forward to working with the Committee in considering the next phase of welfare reform and other elements of the President's proposals to help America's low-income families succeed.

Temporary Assistance for Needy Families

As a former Governor, I can tell you that the Temporary Assistance for Needy Families program—or TANF—has been a truly remarkable example of a successful Federal-State partnership. States were given tremendous flexibility to reform their welfare programs and as a result, millions of families have been able to end their dependency on welfare and achieve self-sufficiency.

Since 1996, welfare dependency has plummeted. As of September of 2001, the number of families receiving assistance, which represents the welfare caseload, was 2,103,000 and the number of individuals receiving assistance was 5,343,000. This means the welfare caseload and the number of individuals receiving cash assistance declined 52 percent and 56 percent, respectively, since the enactment of TANF. Between January and September of last year national caseloads actually declined about 2 percent, and while the July to September statistics indicate a slight increase, the figures are still well below the previous year's caseload levels. The general trend suggests the national caseloads are not rising but, instead, have stabilized.

In New York City, where we are understandably most concerned about job opportunities, they have achieved more than 53,000 job placements for welfare recipients from September through December 2001. While the number of TANF recipients increased briefly directly because of the tragedy on September 11, by December there were about 15,000 fewer TANF recipients on the rolls than there were in August. Indeed, in December the City had its lowest number of persons on welfare since 1965.

Some other positive outcomes we have seen since the law's passage include:

- Employment among single mothers has grown to unprecedented levels.
- Child poverty rates are at their lowest level since 1978. Overall child poverty rates declined from 20.5 percent in 1996 to 16.2 percent in 2000. The poverty rate among African American children declined from 39.9 percent to 30.9 percent—the lowest level on record. The poverty rate among Hispanic children declined from 40.3 percent to 28.0 percent—the largest 4-year drop on record.
- The rate of births to unwed mothers has not increased.

But even with this notable progress, much remains to be done, and States still face many challenges. Last year, I held eight listening sessions throughout the country to discuss the state of their TANF systems and understand the new challenges they are facing. The States overwhelmingly support this program. While keeping the basic structure and purpose of the program, States, administrators, recipients, employers, and advocates have provided valuable insight into where we could make the program even more responsive to the needs of families.

In the near future, we plan to unveil our reauthorization proposal to build on current successes of the program. Our reauthorization proposal embraces the needs of families by maintaining the program's overall funding and basic structure, while focusing increased efforts on building stronger families through work and job advancement and adding child well-being as an overarching goal of TANF.

Our budget proposes $16.5 billion each year for block grants to States and Tribes; $319 million a year to restore supplemental grants; $2 billion over 5 years for a more accessible Contingency Fund; and a $100 million a year initiative for research, demonstration and technical assistance primarily to promote child well-being through strengthening family formation and healthy marriages. In addition, our proposal will call for modification of the bonus for high performance to reward significant achievement in promoting employment of program participants.

We maintain State flexibility, but include important changes to improve the effectiveness of the program. We will also expect States to engage all families they serve and help them make progress toward their highest degree of self-sufficiency—even those cases that may appear hard to employ. We will eliminate the separate two-parent work participation rates and give States more flexibility in designing productive self-sufficiency activities while ensuring that the participation rate requirements are meaningful. We will also ask States to set performance goals for their TANF programs and report on their progress toward meeting these goals.

I look forward to working with the Committee on reauthorization of this hallmark program. I am confident that together we will witness even greater achievements under the TANF program.

Other Programs Supporting TANF Goals

The President's budget also includes funding for several other programs at the State and Community level that work to support the goals of TANF. The Job Opportunities for Low-Income Individuals program (JOLI), provides grants to non-profit organizations to create new employment and business opportunities for TANF recipients and other low-income individuals. Our budget provides $5.5 million to continue this valuable program. The Individual Development Account (IDA) demonstration program similarly seeks to increase the economic self-sufficiency of low-income families by testing policies that promote savings for post-secondary education, home ownership, and micro-enterprise development. The President's budget calls for $25 million to support IDAs. More broadly, the Social Services Block Grant (SSBG) provides a flexible source of funding for States to help families achieve or maintain self-sufficiency and provide an array of social services to vulnerable families. The President's budget request for SSBG is $1.7 billion.

Child Care

Child Care has played an important role in the success of welfare reform by providing parents the support they need to work. The President's budget recognizes this critical link and maintains a high level of commitment to childcare. Continuing the substantial increase in funding the Congress has provided over the last several years, the President's budget includes a total of $4.8 billion in child care funding in conjunction with our request to reauthorize the mandatory and discretionary funding provided under the Child Care Development Block Grant and the Child Care Entitlement. States will also continue to have significant flexibility under the TANF program and under the Social Services Block Grant program to address the needs of their low-income working families. These additional funding opportunities have substantially increased the amount of resources dedicated to child care needs. For example, in fiscal year 2000 States transferred $2 billion in TANF funds to the Child Care and Development Block Grant.

Child Support Enforcement

The Child Support Enforcement program offers another vital connection to families' ability to achieve self-sufficiency and financial stability. The President's budget proposes to increase child support collections and direct more of the support collected to families transitioning from welfare—goals this Committee has supported vigorously. Under our proposal, the Federal Government would share in the cost of expanded State efforts to pass through child support collections to families receiving TANF. Pass through payments enhance a family's potential for achieving self-sufficiency while also creating incentives for non-custodial parents to pay support and custodial parents to cooperate in securing support. Similarly, States would be given the option to adopt simplified distribution rules that ease State administration but, more importantly, benefit families that have transitioned from welfare by directing support otherwise retained by the State and Federal Governments to these families.

Overall collections would be increased by expanding our successful program for denying passports to parents owing $2,500 in past-due support, requiring States to update support awards in TANF cases every 3 years, and authorizing States to offset certain Social Security Administration payments when they determine such action would be appropriate to collect unpaid support. Our child support legislative package would also impose a minimal annual processing fee in any case where the State has been successful in collecting at least $500 of support for the year on behalf of a family that has never received assistance.

Strengthening Families

The fiscal year 2003 budget contains funds for four competitive grant programs, targeted at community and faith based organizations, to assist in delivering innovative services, to strengthen families and help change lives. The Compassion Capital Fund, at $100 million, will expand the capacity of groups and organizations willing to step up and help provide these critical social services. $20 million is included to encourage and help fathers improve their ability to manage family business affairs. Children who have parents in prison are in need of mentoring support by a caring adult, $25 million is requested for this effort. Finally, young pregnant mothers and their children will be provided safe environments through the $10 million included for Maternity Group Homes.

Promoting Safe and Stable Families

I appreciate this Committee's tremendous support for our efforts to help American families, most recently your work shepherding through to enactment the President's initiative to reauthorize and expand the Promoting Safe and Stable Families Program. The President's budget would increase the funding level for this program to $505 million, fully supporting the increased authorization included in the new law. These funds will be used to help promote and support adoption so that children can become part of a safe and stable family, as well as for increased preventive efforts to help families in crisis.

Our budget also supports the new authority for funding the mentoring children of prisoners initiative included in the legislation and advanced by the President in last year's budget. The budget requests $25 million for grants to provide a range of activities to mentor children of prisoners.

This landmark legislation also authorized a new program to provide vouchers to youth who are aging out of foster care so that they can obtain the education and training they need to lead productive lives. The President's budget includes $60 million for these vouchers, bringing the total request for the Foster Care Independence Program to $200 million.

Child Welfare/Foster Care/Adoption

Our budget framework includes resources for a number of additional programs targeted to protecting our most vulnerable and at-risk children. Foster Care, Adoption Assistance, Adoption Incentives and Child Welfare Services are designed to enhance the capacity of families to raise children in a nurturing, safe environment. The President's budget provides resources to help States provide safe and appropriate care for children who need placement outside their homes, and to provide funds to States to assist in providing financial and medical assistance for adopted children with special needs who cannot be reunited with their families, and to reward States for increasing their number of adoptions. At the same time, the budget also supports Child Welfare Services programs with the goal of keeping families together when possible and in the best interest of the child.

The budget provides nearly $4.9 billion for Foster Care, $1.6 billion for Adoption Assistance, and $43 million in Adoption Incentive funds. In addition, the President's budget seeks almost $300 million in funding for child welfare services and training. Together, these funds will support improvement in the healthy development, safety, and well being of the children and youth in our Nation.

Abstinence Education

The President's Budget proposes to reauthorize $50 million in mandatory funding for Abstinence Education grants to States. These resources complement Abstinence Education grants to community-based organizations ($73 million). Both grants will continue to support the message, through mentoring, counseling and adult supervision, that abstinence from sexual activity is the only sure way for teens to avoid out-of-wedlock pregnancies and sexually transmitted diseases.

Repatriation

Finally, our commitment to supporting America's families does not stop at our borders. The President's budget seeks $1 million in funding for the Repatriation program to assist United States citizens and their dependents returning from foreign countries under extreme circumstances.

INCREASING ACCESS TO HEALTH CARE

The issues that have confronted the Nation in the past 6 months will have far reaching effects. Of all the issues confronting this Department, none has a more direct effect on the well-being of our citizens than the quality and accessibility of health care. Our budget proposes to improve the health of the American people by taking important steps to increase and expand the number of Community Health Centers, strengthen Medicaid, and ensure patient safety.

Community Health Centers provide family oriented preventive and primary health care to over 11 million patients through a network of over 3,400 health sites. The fiscal year 2003 budget will increase and expand the number of health enter sites by 170, the second year of the President's initiative is to increase and expand sites by 1,200 and serve an additional 6.1 million patients by 2006. We propose to increase funding for these Community Health Centers by $114 million. Our long-term goal is to increase the number of people who receive high quality primary healthcare regardless of their ability to pay. With these new health centers we hope to achieve this goal.

The Medicaid program and the State Children's Health Insurance Program (SCHIP) provide health care benefits to low-income Americans, primarily children, pregnant women, the elderly, and those with disabilities. The fiscal year 2003 budget we propose strengthens the Medicaid and SCHIP programs by implementing essential reforms.

As a first step, we propose to build on the Health Insurance Flexibility and Accountability (HIFA) demonstration initiative, which would give states the flexibility they need to design innovative ways of increasing access to health insurance coverage for the uninsured. In addition to HIFA, the Administration's plan would allow those who receive the President's health care tax credit to increase their purchasing power by purchasing insurance from plans that already participate in their State's Medicaid, Children's Health Insurance, or State employees' programs.

This could help keep costs down and provide a more comprehensive benefit than plans in the individual market.

We also need to make an effort to narrow the drug treatment gap. As reflected in the National Drug Control Strategy, Substance Abuse and Mental Health Services Administration estimates that 4.7 million people are in need of drug abuse treatment services. However, fewer than half of those who need treatment actually receive services, leaving a treatment gap of 3.9 million individuals. Our budget supports the President's Drug Treatment initiative, and to narrow the treatment gap. We propose to increase funding for the initiative by $127 million. These additional funds will allow States and local communities to provide treatment services to approximately 546,000 individuals, an increase of 52,000 over fiscal year 2002.

STRENGTHENING MEDICARE

The fiscal year 2003 budget dedicates $190 billion over 10 years for immediate targeted improvements and comprehensive Medicare modernization, including a subsidized prescription drug benefit, better insurance protection, and better private options for all beneficiaries. Last year, President Bush proposed a framework for modernizing and improving the Medicare program that built on many of the ideas that had been developed in this Committee and by other Members of Congress. That framework includes the principles that:

- All seniors should have the option of a subsidized prescription drug benefit as part of modernized Medicare.
- Modernized Medicare should provide better coverage for preventive care and serious illness.
- Today's beneficiaries and those approaching retirement should have the option of keeping the traditional plan with no changes.
- Medicare should make available better health insurance options, like those available to all Federal employees.
- Medicare legislation should strengthen the program's long-term financial security.
- The management of the government Medicare plan should be strengthened to improve care for seniors.
  •Medicare's regulations and administrative procedures should be updated and streamlined, while instances of fraud and abuse should be reduced
- Medicare should encourage high-quality health care for all seniors.

The improvements the President and I have proposed include not only a subsidized drug benefit as part of modernized Medicare, but also providing better coverage for preventive care and serious illness. Thus, we propose that preventive benefits have zero co-insurance and be excluded from the deductible. We must make these improvements to more effectively address the health needs of seniors today and for the future.

Let me assure you, the President remains committed to the framework he introduced last summer, and to bringing the Medicare program up to date by providing prescription drug coverage and other improvements. We cannot wait: it is time to act. Recognizing that there is no time to waste, the President's Budget also includes a series of targeted immediate improvements to Medicare.

As you know, last year the President proposed the creation of a new Medicare-endorsed prescription drug card program to reduce the cost of prescription drugs for seniors. This year, HHS will continue working to implement the drug card program, which will give beneficiaries immediate savings on the cost of their medicines and other valuable pharmacy services. The President is absolutely committed to providing immediate assistance to seniors who currently have to pay full price for prescription drugs.

Assistance, however, will not come only through the prescription drug card program. The budget proposes several new initiatives to improve Medicare's benefits and address cost. This budget proposes additional Federal assistance for comprehensive drug coverage to low-income Medicare beneficiaries up to 150 percent of poverty—about $17,000 for a family of two. This policy would eventually expand drug coverage for up to 3 milllion beneficiaries who currently do not have prescription drug assistance, and it will be integrated with the Medicare drug benefit that is offered to all seniors once that benefit is in place. This policy helps to establish the framework necessary for a Medicare prescription drug benefit and is essentially a provision that is in all of the major drug benefit proposals to be debated before Congress. That is, the policy provides new Federal support for comprehensive prescription drug coverage for low-income seniors up to 150 percent of poverty. And in all the proposals, the Federal Government would work with the States to provide this coverage, just as we are proposing with this policy.

Recently, I announced a model drug waiver program—Pharmacy Plus—to allow States to reduce drug expenditures for seniors and certain individuals with disabilities with family incomes up to 200 percent of the Federal poverty level. This program is being done administratively. The recently approved Illinois initiative illustrates how states can expand coverage to Medicare beneficiaries in partnership with the Federal Government. The Illinois program will give an estimated 368,000 low-income seniors drug coverage. The model application I have announced is easy to understand and use, and the Centers for Medicare and Medicaid Services is working with numerous States—at least 12—that have already expressed interest in this program. Making it easier for States to take similar steps to help their citizens who need help the most is the goal I believe we all share.

The President's budget also includes an increase in funding to stabilize and increase choice in Medicare+Choice program by aligning payment rates more closely with overall Medicare spending and paying incentives for new types of plans to participate. Over 500,000 seniors lost coverage last year because Medicare+Choice plans left the program. Today over 5 million seniors choose to receive quality health care through the Medicare+Choice program. Because it provides access to drug coverage and other innovative benefits, it is an option many seniors like, and an option we must preserve. The President's budget also proposes the addition of two new Medigap plans to the existing 10 plans. These new plans will include prescription drug assistance and protect seniors from high out-of-pocket costs.

Some of these initiatives give immediate and tangible help to seniors. But, let me make clear: these are not substitutes for comprehensive reform and a universal drug benefit in Medicare. They are immediate steps we want to take to improve the program in conjunction with comprehensive reform, so that beneficiaries will not have to wait to begin to see benefit improvements. I want to pledge today to work with each and every member of this Committee to fulfill our promise of health care security for America's seniors—now and in the future.

SUPPORTING HEALTHY COMMUNITIES

The fiscal year 2003 budget includes $25 million for a Healthy Communities Innovation Initiative—a new interdisciplinary services effort that will concentrate Department-wide expertise on the prevention of diabetes and asthma, as well as obesity. The purpose of the initiative is to reduce the incidence of these diseases and improve services in 5 communities through a tightly coordinated public/private partnership between medical, social, educational, business, civic and religious organizations.

More than 16 million Americans currently suffer from a preventable form of diabetes. Type II diabetes is increasingly prevalent in our children due to the lack of activity. In a recent study conducted by NIH, participants that were randomly assigned to intensive lifestyle intervention experienced a reduced risk of getting Type II diabetes by 58 percent. The Healthy Communities Initiative makes preventing Type II diabetes in kids a priority. HHS plans to reach out to women and minorities to help make this initiative a success.

IMPROVING MANAGEMENT AND PERFORMANCE OF HHS PROGRAMS

I am committed to being proactive in preparing the Nation for potential threats of bioterrorism and supporting research that will enable Americans to live healthier and safer lives. And, I am excited about beginning the next phase of Welfare reform and strengthening our Medicare and Medicaid programs. Ensuring that HHS resources are managed properly and effectively is also a challenge I take very seriously.

For any organization to succeed, it must never stop asking how it can do things better, and I am committed to supporting the President's vision for a government that is citizen-centered, results oriented, and actively promotes innovation through competition. HHS is committed to improving management within the Department and has established its own vision of a unified HHS—One Department free of unnecessary layers, collectively strong to serve the American people. The fiscal year 2003 budget supports the President's Management Agenda.

The Department will improve program performance and service delivery to our citizens by more strategically managing its human capital and ensuring that resources are directed to national priorities. HHS will reduce duplication of effort by consolidating administrative management functions and eliminating management layers to speed decision-making. The Department plans to reduce the number of personnel offices from 40 to 4; centralize the public affairs and legislative affairs functions; and consolidate construction funding, leasing, and other facilities management activities. These management efficiencies will result in an estimated savings of 700 full time equivalent positions, allowing the Department to redeploy staff and other resources to line programs.

HHS continues to be at the forefront of the Government-wide effort to integrate budget and performance. We were one of the first Departments to add tables to its GPRA Annual Performance Reports that provide summary tables that associate resource dollars and performance measures HHS-wide. Although we work in a challenging environment where health outcomes may not be apparent for several years, and the Federal dollar may be just one input to complex programs, HHS is committed to demonstrating to citizens the value they receive for the tax dollars they pay.

By expanding our information technology and by establishing a single corporate Information Technology Enterprise system, HHS can build a strong foundation to re-engineer the way we do business and can provide better government services at reduced costs. By consolidating and modernizing existing financial management systems our Unified Financial Management System (UFMS) will provide a consistent, standardized system for departmental accounting and financial management. This "One Department" approach to financial management and information technology emphasizes the use of resources on an enterprise basis with a common infrastructure, thereby reducing errors and enhancing accountability. The use of cost accounting will aid in the evaluation of HHS program effectiveness, and the impacts of funding level changes on our programs.

HHS is also committed to providing the highest possible standard of services and will use competitive sourcing as a management tool to study the efficiency and performance of our programs, while minimizing costs overall. The program will be linked to performance reviews to identify those programs and program components where outsourcing can have the greatest impact. Further, the incorporation of performance-based contracting will improve efficiency and performance at a savings to the taxpayer.

GOVERNMENT PERFORMANCE AND RESULTS ACT

HHS is committed to continual improvement in the performance and management of its programs and the Administration's efforts to provide results-oriented, citizen-centered government. The budget request for fiscal year 2003 is accompanied by annual performance plans and reports required by the Government Performance and Results Act (GPRA). The performance measures cover the wide range of program activities essential to carrying out the HHS mission. Some notable fiscal year 2001 achievements include:

–Reducing Erroneous Medicare Panents: CMS has continued to reduce the payment error rate from 14 percent in fiscal year 1996 to 8 percent in fiscal year 1999 and 6.8 percent in fiscal year 2000 and exceeding its targets in both fiscal year 1999 and fiscal year 2000. CMS, with the assistance of the Office of the Inspector General, is committed to further reducing the error rate to 5 percent by fiscal year 2002.

–Moving Families Toward Self-sufficiency: ACF reported that 42.9 percent of adult recipients of TANF were employed by fiscal year 1999. This is a primary indicator of success in moving families toward self-sufficiency. It improves on the fiscal year 1998 baseline of 38.7 percent and exceeds the target of 42 percent.

–Families Benefiting from Child Support Enforcement: The Child Support Enforcement program broke new records nationwide in fiscal year 2001 by collecting $18.9 billion, one billion over fiscal year 2000 levels. In one such initiative in fiscal year 2000, the government collected a record $1.4 billion in overdue child support from Federal income tax refunds, and more than 1.42 million families benefited from these collections.

These are just a few of the dozens of impressive success stories found in the 13 performance plans and reports. GPRA has been and will continue to be an important part of our effort to improve the management and performance of our programs.

WORKING TOGETHER TO ENSURE A SAFE AND HEALTHY AMERICA

Mr. Chairman, the budget I bring before you today contains many different elements of a single proposal; what binds these fundamental elements together is the desire to improve the lives of the American people. All of our proposals, from building upon the successes of welfare reform, to protecting the Nation against bioterrorism; from increasing access to healthcare, to strengthening Medicare, are put forward with the simple goal of ensuring a safe and healthy America. I know this is a goal we all share, and with your support, we are committed to achieving it.

Chairman CONRAD. Thank you, Mr. Secretary. Thank you for that testimony. Let's go to the question that I raised in my opening statement that is of great concern to me. Could we put up that chart?

Could you tell me how is it—and I know this is over in OMB, they came up with these numbers. I said I believe they have cooked the books here. I don't know what other conclusion one would come to, when they have got an estimate for increases in health care that we have not seen in anyone's recent memory, and no objective observer believes they are credible.

Compared to the Congressional Budget Office, OMB has underestimated the cost of Medicare over this decade by $300 billion, and here is why: Medicare costs under OMB are projected to go up 3.5 percent a year. CBO says they are going up 5 percent a year. Private health insurance spending on a per capita basis is going up 6.1 percent a year. Last year medical inflation was 4.7 percent.

These sound like small differences. These small differences add up to huge amounts of money.

Secretary THOMPSON. Yes.

Chairman CONRAD. Do you have any understanding of how they justify this?

Secretary THOMPSON. Senator, let me attempt to explain to the best of my ability. It is my understanding that over the next 10 years, the growth estimated by our actuaries at the Centers for Medicare Services is 5.7 percent. CBO's is 7.2 percent. That makes a difference over 10 years of $359 billion, as you have indicated.

I have the actuary here from the Centers for Medicare and Medicaid Services, Rick Foster, who has been the chief actuary for Medicare cost analysis for the last several years. He is the same individual that the Clinton administration used, the same one the we are using. OMB took the figures directly from the actuaries. These are professional individuals. They have, I think, some of the best analysts possible. We have 50 individuals that have analyzed it, and they have indicated that these are the figures.

Some of the reasons—I asked the same questions you did, Senator Conrad. How could that possibly be? One of the things that they have indicated is that the level of medical usage is stabilizing, and they expect more stabilization in the outer years.

Second, the prospective payments for doctors, which went down 5.4 percent, were included in the analysis of CMS, which was not included, to the best of my knowledge at this time, at CBO. And it is also my understanding that CBO is going to make some adjustments, some modifications in their figures in March of this year, and will also be working with the actuaries at CMS.

So if, in fact, CBO still has those same figures in March, I think we are going to have to sit down with CMS and make some reconciliations. But right now CMS, as of last night when I talked to them—and Rick Foster (who is the chief actuary) is here—stands by his numbers, and these are the exact numbers that he gave OMB and OMB put them in the budget. And as I understand it, OMB in the Clinton administration, the OMB in the previous Bush administration, and this current Bush Administration takes the actuary numbers from CMS directly and never changes them or modifies them at all.

Chairman CONRAD. Let me just say that I think a reality test, just kind of a common-sense reality test, would say it is very unlikely. I am told our people have done an analysis that these assumptions would say Medicare will grow more slowly in the next decade than it has in any 10-year period since its creation. Is that credible? Here we are, the baby boomers start to retire in 6 years, they become eligible for Medicare, and we are saying that the costs of the program that is the biggest program that they are eligible for other than Social Security is going to grow at the lowest rate since the inception of the program?

It is not credible with me, and it is not the CBO's analysis. And I can tell you, I have had outside experts that we have consulted who term this estimate laughable. Laughable. These are outside health experts who have looked at this, looked at the trend lines in terms of the number of people eligible, and they say this is a vast understatement of what the costs will be.

Secretary THOMPSON. Senator Conrad, all I can say is that I have turned to the economists and the chief actuary of CMS, and as I understand it, it is the same actuary system that has been used by this Congress and by previous Administrations and the current Administration, and I looked to him, and I asked him again last night, was this credible, and he nods in the affirmative. And so I have to rely upon my expert, Senator Conrad, and that is what I am relying on.

Chairman CONRAD. Well, I understand. I am just saying I do not think it is credible. I think a common-sense reality test would tell us it is not credible. And you know, I believe this is how we get into trouble, understating what costs are going to be.

Let me go to the prescription drug question.

Secretary THOMPSON. OK.

Chairman CONRAD. Because that has been raised. Let us put up that chart that shows prescription drug costs. The President is calling for $190 billion for prescription drugs. Last year's budget resolution agreed to in the House and the Senate provided $300 billion, so this is a 37 percent cut from what Congress provided last year. And it is an estimate and a provision of a 37 percent reduction from what Congress did last year at a time the costs are skyrocketing. They have told us that providing the same benefit $300 billion would have provided last year would cost $400 billion now. And yet the President provides $190 billion.

Again, the reality test. I went and asked how much it would cost to provide the same prescription drug benefit that all Federal employees are eligible for. The answer was $750 billion. Seven hundred and fifty billion to provide the prescription drug benefit that Federal employees have. That is the column on the right.

Last year's budget, prepared by Congress, provided $300 billion. The President's budget is $190 billion. How are you going to provide any kind of serious prescription drug benefit with about a quarter of the money that it would take to provide the benefit every Federal employee has, that the President has, that you have, that I have, that every member of this panel has?

Secretary THOMPSON. Senator, the President feels and the Administration feels very strongly that we have to start someplace, and $190 billion is, we think, a tremendous effort on the part of this Administration for developing prescription drug coverage and at the same time strengthening Medicare.

If it was only prescription drug coverage, I could understand that your figures would be much more in line, but if you do the necessary reforms, the necessary strengthening of Medicare, and add some of the other things and make some of the adjustments, we feel that we can develop a very comprehensive package at $190 billion over 10 years, and that is where we got our figures, once again, the Center for Medicare and Medicaid Services. It went through OMB——

Chairman CONRAD. These are the same actuaries?

Secretary THOMPSON. We used the same actuaries, Senator, and——

Chairman CONRAD. I think we had better get some new actuaries over there. Let me go to——

Secretary THOMPSON. I have known them for many years, sir, and they have always proven to be correct, and I have a great admiration for their professionalism, Senator.

Chairman CONRAD. Well, I appreciate your confidence in them. I don't share that confidence, and I doubt very much that what we face in the future will match their numbers.

Let me go to the final question I have, and that is, absent from this budget is any funding for provider payment adjustments, despite the Medicare Payment Advisory Commission's recommendations last month for increases in Medicare's provider payment systems.

Chairman Thomas of the House Ways and Means Committee expressed concern about this matter.

Secretary THOMPSON. He did.

Chairman CONRAD. And we have an indication from him, they anticipate it may cost as much as $174 billion over the next 10 years, and there is no provision for it in the budget. Can you explain that?

Secretary THOMPSON. Well, Senator Conrad, the reason being is we had to make some tough choices. And number 2, we complied with the law in making the prospective payments adjustments, evidenced by the law that was passed in 1989, modified in 1997 and 1999, and we complied with that law. When you have an uptick in the economy, the prospective payments show increases. When you have a downturn, which we have had this past year, there has been a reduction in the payments to doctors, which is a reduction of 5.4 percent, which brought this to the forefront.

Chairman CONRAD. But there is no legal requirement that you provide for adjustments that are recommended by your own commission.

Secretary THOMPSON. That is very true. But when we looked at it, we did not have the money available for making any further adjustments. We tried to come in with as close to baseline as we possibly could. We also told Chairman Thomas that we would work with the Ways and Means Committee, and that same promise I give to you, Senator, and to this Committee, that we will work with you. But I think it is important if we are going to look at the prospective payments for doctors, we should look at the prospective payments for all the providers, put them all on the table, work together in a comprehensive manner to see if we cannot solve it. Because the law right now, the way it is written, creates some problems for making the prospective payments. I am not blaming anybody. I am just saying this is the law, and I would like to work with you to try and improve it and to modernize it wherever we possibly can.

Chairman CONRAD. Let me just say I appreciate your attitude. I just say to you that I just don't see this budget as adding up. I honestly do not, and it starts at a much higher level than you, and that involves most directly the Office of Management and Budget. But I see this as just filled with problems, and it is going to be very difficult to craft a budget when this is the thing that has been sent to us. And I do not think it is a realistic proposal. I think it badly understates the costs of Medicare. I think it is completely inadequate with respect to prescription drugs, and there is no provision for adjustments to providers that are recommended by your own commission, and these are tremendous amounts of money.

With that, we will go to—Senator Frist was going to ask Senator Smith to go next on your side.

Senator SMITH. Thank you, Mr. Chairman. I have an opening statement. I would like to include it in the record, and my questions will incorporate some of it.

Chairman CONRAD. Without objection.

OPENING STATEMENT OF SENATOR GORDON SMITH

Good morning Mr. Secretary and fellow Senators.

Mr. Secretary, I am glad to welcome you before the Senate Budget Committee this morning of all mornings—Valentine's Day—a day when people around the world show how much they care for others—a day when we should not be afraid to show that we have a heart.

THE UNINSURED

Last Monday we received President Bush's budget for 2003. I would like to express my appreciation to the Administration for taking a strong leadership role in the proposed fiscal year 2003 budget with regards to the uninsured. I am impressed by your initial size and apparent scope of the Administration's commitment to decreasing the numbers of uninsured Americans. Setting aside $89 billion is a good start in our efforts to provide health care coverage to the most needy.

However, even according to the Administration's own estimates, his proposal will only reach 6 million of the uninsured next year. There are 40 million uninsured people in this country—and the number is growing. Just yesterday, families USA released the finding that 2.2 million Americans lost their health coverage last year because of layoffs. This is the biggest yearly jump in the uninsured population in a decade.

And this is a conservative estimate! it only approximates the loss of health coverage caused by job layoffs. It does not include any effect of increased health care costs, or State medicaid program cutbacks.

Therefore, as a result of the 2001 increase, the number of uninsured people in America now exceeds the cumulative population of 23 States plus the District of Columbia. I want to urge everyone listening to read more about this problem. Go to *www.coveringtheuninsured.org.*

I have long fought for greater awareness of breast cancer—and there is a horrifying statistic on that website women with breast cancer are 49 percent more likely to die if they are uninsured.

We MUST do something THIS YEAR to address this growing problem. In the past, I have worked with both Republicans and Democrats on this important issue, and this year I intend to seek bipartisan support again for setting aside additional funds to cover the uninsured.

I believe we must commit a greater sum of money if we are to make a realistic effort to cover all 40 million—and growing—uninsured Americans. It is a national disgrace that so many people who live and work among us do not have affordable access to this most basic human need.

While there is no agreement as to exactly how to expand coverage for all Americans, it seems fairly clear that the only feasible way is through some combination of private incentives and public expansions. We must be prepared to work together to find compromise if we are going to ever do more than simply talk about the uninsured.

Mr. Secretary, I'm very happy we've begun to address the problem of the uninsured, but we are only helping 6 million people this year . . .it reminds me of the school children on Valentine's Day who only bring Valentine's for a selected few in their class, leaving the others empty handed. Let's send a Valentine to every child—we need to insure all Americans.

Senator SMITH. Mr. Secretary, thank you for being here. I think your record as the Governor of Wisconsin in health care reform is wonderfully propitious for our country's sake, and I think the job you are doing, both in the reform front and the war front, on the homefront, is very much appreciated by this Senator.

I wrote yesterday, Mr. Secretary, a letter to President Bush about my ongoing concern for the issue of the uninsured, and I do think your budget has made a very good start on closing this gap. I have referred to 40 million uninsured Americans in the past as a moral omission on the part of our country.

I would like to propose to you that if President Bush as a Republican would grab as his own the issue of eliminating the ranks of the uninsured, it would be his version of Nixon going to China, and I would like to suggest that would be good for our country.

As I understand your budget, we are going to cover an additional 6 million Americans. That leaves 34 million Americans still uncovered. I have worked in the past with Senator Wyden, my colleague from Oregon, and other Republicans and Democrats to try and figure out a more comprehensive approach to eliminating this moral omission that would include not only health care credits that you are providing but also deductions for small businesses that don't now offer health care, and an even more significant expansion of community health centers. Perhaps with some combination like this, we could answer the question to the rest of the world that the greatest Nation in the world does provide health care to all of its citizens.

I wonder if you are open to working with us, not in future years but this year, to find a more comprehensive package than has been proposed in the budget of credits, deductions and expanded health care centers. You can help us to figure out how to pay for it and identify some efficiencies that our system does not allow now.

We are spending an awful lot on health care. It does seem to me that with what Wisconsin has done, what Oregon has done, there are ways to get more people insured with the dollars we are already spending.

I wonder if you would work with us, to that end, and if you have any thoughts you could share with me today.

Secretary THOMPSON. Well, thank you very much for the question, Senator Smith, because, you know, this is something that needs to be done. We need to look at the uninsured and find ways in which we can solve this particular problem. And I think we have to do it on a bipartisan basis, and I think there are a lot of individuals on both sides who would like to do something.

I would like to point out that $89 billion in health credits is a giant step forward.

Senator SMITH. It is big.

Secretary THOMPSON. It should cover 6 million Americans, and it also allows you to go in right away and get the credit and then take that credit to your insurance agent and buy health coverage.

The second thing I did not mention, which is also going to be very helpful, is allowing small businesses to form pools, and not only within the particular State of Oregon, but go into the State of Washington and Idaho, and so on and so forth, and get an expanded pool so that small businesses would have a better opportunity to do it.

Three, expanding community health centers is something tremendously needed, and you did not mention the $77 billion for immediate help in regard to prescription coverage for those that are on Medicare.

Senator SMITH. Yes.

Secretary THOMPSON. Up to 150 percent of poverty. The Federal Government will pay 90 percent between 100 and 150 percent.

I also would point out for you a program that I started in Wisconsin—and I know Oregon has now got a waiver in front of the Department that we are reviewing, or will be reviewing. We have also expanded that Badger care kind of coverage in Massachusetts and in New York where there are going to be 650,000 more low-income families covered. It was also approved in California and Arizona and Utah. We have been able to expand that by 1.8 million Americans by allowing waivers to be used under the S–CHIP program to give low-income working parents an opportunity to be covered as the children, with the State assuming a good share of the responsibility. But it extends it, and this is a program that has tremendous potential nationally, and I would like you to take a look at that.

Senator SMITH. I would be happy to look at that with you.

Secretary THOMPSON. I do want to work with you, absolutely.

Senator SMITH. Well, we want to do this. I met with Tom Scully the other day, and he had many ideas as well.

Secretary THOMPSON. We are not short of ideas over in the Department.

Senator SMITH. We just need to implement them, because I think for all of our great credits as a country, our lack of health care coverage for the working uninsured is not one of those credits. It is certainly a debit in my mind.

Can you describe in more detail what the Administration has in mind in terms of approaches to Medicaid and S–CHIP without seeking waivers? Is that the proposal on the table?

Secretary THOMPSON. There is no expansion of S–CHIP right now. I certainly think we should be looking at that. But there is nothing in this budget to expand the S–CHIP program except for the $3.5 billion that would go back to the Treasury for States that had not used that money. The President has indicated it is a great program, and that money should be left out there for the States to use to cover children, and hopefully we can also cover low-income working families, because I have found from the experience that I have had, both as Governor and now as the Secretary, that more families are willing to take their children to get covered if, in fact, they are ale to sign up for coverage as well.

In regard to the $77 million. That is for prescription coverage. It is not Medicaid or an S–CHIP. It is a new program in which the States will receive the regular the Federal MAP rate up to 100 percent, and then receive 90 percent FMAP from 100 to 150 percent, which will help a lot of States in offering prescription drug coverage for seniors and those that are disabled.

Senator SMITH. Mr. Secretary, just a closing comment that I had. I recently visited a community health center in Clackamas County, Oregon. They indicated to me they could serve so many more people if there were more resources from the Federal Government to counties, and somehow we have got to redirect the thinking of the uninsured not to go to the emergency room, but to go to a community health center.

Secretary THOMPSON. Absolutely.

Senator SMITH. And I do not know how you get there, but somehow there needs to be coordination with emergency rooms to tell people, If you don't have an emergency, go to the community health center. It is there, it is available, it is inexpensive. We just need more of them.

Secretary THOMPSON. We have got 3,300 right now. We are going to add an additional 170 in this budget if Congress goes along with the President's recommendation. Congress has been very generous. Last year we asked for 125 and Congress came in with 175 million. We have been able to add an additional 200. I know Senator Bond has led this effort, and I cannot tell you how impressed I am with the care, the quality of care that people receive at the community health centers. It is excellent.

Senator SMITH. It is.

Secretary THOMPSON. We need to do more, and by this budget and by the President's commitment, your commitment, and the bipartisan commitment, I am fairly confident we will meet our goal of going from 11 million people in America being able to utilize community health centers to 20 million. That is the goal, and we are looking to expand the numbers by 1,200 over the course of the next several years, and I think that is going to encourage more people to use them, keep them out of the emergency rooms and get them into the community health centers where they get primary care which is very good care for them.

Senator SMITH. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Last year I proposed a $4 billion supplemental as Chairman of the Appropriations Committee for bioterrorism, focusing on developing the capacity of the State and local hospitals and clinics to respond to bioterrorist attacks and to purchase smallpox vaccine and anthrax antibiotics. Dr. Frist says we need to respond today.

The President opposed that package. He opposed it as being too large and too early. Now the President is requesting over $4 billion for fiscal year 2003 for bioterrorism programs at HHS, but under his 2003 request this funding would not be available for almost a year. If he had not opposed the funding that I proposed last year, it would have been available now. That funding went down on a

60-vote point of order, and Senators walked in lockstep to the President's leadership in opposing that money at that time.

I find this mystifying. The money would have been available now.

We are right now working under the fourth alert. We are under an FBI alert now, and yet that money was opposed by this Administration. They said it was too large, too early.

Don't State and local governments need these resources for their hospitals and clinics this year to respond to the terrorist threat, Mr. Secretary?

Secretary THOMPSON. First let me congratulate you, Senator Byrd, on your leadership on this bioterrorism initiative. You and I have talked about it, and I compliment you for it.

Senator BYRD. Thank you.

Secretary THOMPSON. As you know, we received $3 billion on the supplemental appropriation which was signed into law on January 10th. We are sending out $1.1 billion. We sent out the letters within 21 days. We are sending out 20 percent of that money, and we will be sending out the balance of the money within the next 60 or 70 days, as soon as they deliver a plan. We want to make darn sure that money gets out there into the States and into the localities for communication, for education, for planning, for surge capacity for our hospitals and so on.

The President feels that we have to get the planning done before we go to the next step, which is the $4.3 billion that he is requesting in fiscal year 2003.

I also want to point out that we will have 286 million doses of smallpox vaccine by the end of this year, enough for every man, woman, and child.

We have also have in this budget $250 million set aside to purchase a new anthrax vaccine which Dr. Tony Fauci at NIH is working on.

We have also just approved Bioport, and they have met the inspections put out by FDA, Senator, and they should be able to produce 2.5 million doses of anthrax vaccine this year and 3 million doses next year.

So we are in the process of all of these steps that you are very interested in, and I applaud you for it. We think we are going in a very systematic and very comprehensive way.

I would like to point out that we have not invested, as you know, in our local and State public health system for many years, neither at the Federal level nor at the State level. And now one of the good consequences of 9/11 is we have an opportunity to build a good, constructive, and very visionary State public health system, something that you have wanted for a long time, and I compliment you on it. I want to make sure that we deliver it for you, sir.

Senator BYRD. Well, I would hope you deliver it a little faster. I am troubled, if not baffled, that the Department of Health and Human Services has decided to release only 20 percent—only 20 percent—of the $1.1 billion. You said earlier that you released 20 percent. Twenty percent of the $1.1 billion that Congress appropriated for shoring up our State and local public health infrastructure.

Now can you explain to me and to this Committee why States are forced to run a bureaucratic gauntlet before you surrender the remaining 80 percent of these desperately needed funds? Why are we waiting? Here you are—I shouldn't say that. It sounds a little overly personal. But here we are, we would have appropriated that money last year. I offered a package to do it on the floor, and sitting on a 60-vote point of order killed it, said no. And the President led the Administration—this President led the fight against that effort, and you would have had money earlier by far and the people at the State level would have had more money, and earlier, by far than is going to be the case.

Why are the States being forced to run this bureaucratic red-tape gauntlet before you surrender the remaining 80 percent of these desperately needed funds?

Secretary THOMPSON. Senator, we want to make sure that this money is well spent. We want to make darn sure that it is accountable and that we are responsible for developing the best State public health system we can.

The President signed a bill on January 10th. We sent out the letters by the 31st, which is 21 days. We are sending out the 20 percent this Friday or next Monday. We are asking them, the State health departments, to come in and meet with the CDC, the doctors that I have assembled at the Department of Health and Human Services on February 25th. We have got four regional meetings set up by CDC to go out and talk to health departments. We are pulling together the best practices on communication, emergency ward operations, and we are sending those to the State health departments, and we want them to develop the plans by March 15th. They will receive the balance of the 80 percent after they get their plans in, and we have a chance to work with the State health departments so we can develop not only a good State system but a system that will be national in scope so that if something happens in the state of West Virginia, the State of Virginia could also pitch in, or the State of New York, whatever, to help the State of West Virginia.

We want a comprehensive plan that is going to be something that you are going to be proud of, and that is why we are doing it. And we are also going to be able to send out that 80 percent within 60 days after March 15th, and we feel that the States, working with us, we can develop the best comprehensive plan available for a strong local-State system that will work together in cooperation to develop the national system necessary to protect all of our citizens.

Chairman CONRAD. Mr. Secretary, might I say that I appreciate your desire to answer fully. The problem we have is a time constraint with 7-minute rounds.

Secretary THOMPSON. I am sorry.

Chairman CONRAD. And with the number of Senators who are here——

Secretary THOMPSON. I will reduce my answers significantly, Senator.

Chairman CONRAD. Thank you.

Secretary THOMPSON. I have got so much to say. I am sorry.

Chairman CONRAD. Senator Bond.

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

Mr. Secretary, I commend you for all the kind words you said about community health centers. We are going to sign Senator Smith up on the community health center caucus.

As Senator Hollings on this Committee and I have said over the years, the community health centers are the most important part of the safety net. They are really the web of the safety net, and I have visited community health centers all over my State, from the inner city to the suburbs to the most isolated rural areas of the State. When there is somebody with no health insurance or somebody who might even (under one of the safety net programs) get health insurance, if they don't have some place to go where the services are available, the payments, the insurance, does them no good. And in every nook and cranny and every downtown street and every hill and hollow in our State, the community health centers are the safety net, so they should be there.

I would bet, I know it is the same in Wisconsin, in Oregon, in Iowa, in North Dakota and West Virginia. And I commend you for the good things you said about it. But as you pointed out, last year, again with the leadership of Senator Hollings and the support of Senator Frist, we upped the OMB request to $175 million because we were trying to get on a path to double the provision of service by community health centers in 5 years. Your budget is not going to keep us on the path from 10 million to 20 million in 5 years. You say in here you go up about 6 million patients.

This, to me, is a start, but I am disappointed when there is so much emphasis on the safety net that we cannot get it up there, and frankly, we are going to work as best we can to make sure that we get the CHCs on that path to doubling in 5 years, because there is nothing more important than covering the remaining areas that are not covered by CHCs with that kind of available, most efficient, low-cost but effective health care service.

I would appreciate your comments on it.

Secretary THOMPSON. All I can say is I salute you for what you stand for in accomplishing that. Last year we put in $125 million, and the Congress raised it to $175 million. We got over 200 new community health centers. The 114 is going to give us 170 new or remodeled community health centers or expanded community health centers in America. And we are trying to look at the resources that we have. If we had more resources, we certainly could have used it for community health centers, but when you have a budget, you have to put it together, making the tough decision, Senator, and we feel that we are on our glide path to reach our necessary doubling. And so that is the reason, Senator.

Senator BOND. Well, I appreciate your commitment. I disagree with OMB's actions on it. And I will tell you, there is one other area where OMB—and I believe it is OMB that has cut back. It is going to cause a real crisis in health care, and this is something that I have worked on with Senator Collins, with Senator Kerry, Senator Feingold, Senator Mikulski, and that is home health care.

Home health care is now scheduled on October 1, only 8 months away, to be cut another 15 percent. I think Congress probably was justified in saying back in 1997 that home health care was growing too fast, so we told HHS and what is now CMS to save $16 billion in home health care.

Well, your predecessors in HHS and what was then the infamous HCFA—we changed the name, we have repainted the outhouse, we have not changed what goes on there—they have cut the budget so much that the cuts will—the "savings" will exceed $70 billion between 1998 and 2002.

Well, as a result, some 3,500 home health agencies have either closed or stopped serving Medicare patients; 900,000 Medicare beneficiaries were eliminated from the home health benefit.

I went into a small county in northwest Missouri, and I said "your home health care unit shut down because it was costing $400,000. What happened to the 40 patients that you were seeing in home health care?"

Well, some of them died prematurely. Some of them were suffering without home health care, but the rest of them had to go into nursing homes, and the public tab for the ones that had go into nursing homes (who had been served by the $400,000 the home health care unit was receiving in Medicare) are now costing the public tab $1.4 million.

Now, for the life of me, I cannot see why CMS has not gotten the message from Congress that that 15 percent cut, additional cut in home health care, would be disastrous.

Recently MedPAC voted unanimously to recommend that Congress eliminate the additional 15 percent cut, extend the 10 percent add-on to PPS payment for rural beneficiaries by 2 years, eliminate the 1.1 percent reduction in the home health care market basket.

I mean, this makes sense. We see it work. It is the most efficient, effective way of providing service to people who don't really need institutionalization. What data does HHS or CMS have that resulted in OMB's failure to eliminate the cut and provide the additional assistance that MedPAC recommended?

Secretary THOMPSON. Well, Senator, we look at the directions that Congress has given us, and all the prospective payment limits, and we try to comply with the law. And I think it is important for you and for this Congress to sit down with us and look at all the provider payments and see how we can modernize and improve them, along with Medicare in general. And I think that would benefit your home health as well as the doctor payments, the hospital payments, and so on. We have to do that.

All we are doing is following the law right now and trying to make sure that we comply with it.

I do disagree with you in regard to CMS being the same as HCFA. We have made tremendous changes, and we are making more changes each and every day, and I think you are going to be well satisfied by the time we get done with the more efficient and more responsive CMS than it has been in the past. And I can guarantee you it is going to happen. We need to modernize it, and we are in the process of doing that. We need your help to do that, like we do on the prospective payments, Senator.

Senator BOND. Mr. Secretary, I appreciate that, and look forward to working with you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Bond.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Mr. Secretary, I welcome you, and I also want to commend you for your real care about our communities and innovation that you have brought to a lot of the efforts, and so I look forward to working with you over the years on this.

That said, I want to identify with the remarks that Senator Conrad made, and I think the discussion we have already had today sort of reinforces the issue that our overall budget number do not seem to add up, whether it is the Medicare growth rates, which we talked about in actuarial sense, or whether it is reimbursement rates for providers, hospitals, doctors, home health care centers, home providers, and I think it is dangerous that we set up expectations that certain things are going to happen, but we are not going to have the resources to do it. And I think it is extremely tough on the ground for medical providers to make actual plans for how these things are going to roll out. And, you know, I think it is even harder for our seniors with regard to prescription drugs. $190 billion in no way is meeting the kinds of expectations that I think people are going to count on.

So there is a whole host of areas that I think our projected budget numbers do not meet what reality is going to be, and I think we are sort of kidding ourselves about where we are going to be over the next decade with regard to costs, and it is extraordinarily dangerous.

In that same vein, last year—and I will change subjects because I think Senator Conrad went through that—the State spent 2 billion more on TANF funds they received from the block grants. I know you care about this program. And we have frozen TANF numbers as we go forward in the budget, and this is an excruciating problems for our States that already have serious budget problems in the current environment. And I cannot imagine that you are not concerned, as a former Governor, about the freeze levels, funding, that we have on these programs given the need to continue to improve this welfare-to-work initiative that you have taken. And in many ways I am very supportive, but I think that making sure that Welfare to Work is appropriate is certainly another case.

And I just say you can go through the S–CHIP programs and see the same sorts of things. New Jersey uses all of the funds and gets reallocated funds from other places, other States. It is very unclear whether that is going to continue. We need to understand that for planning purposes. I just do not think we are talking about truth in what is going to be spent in these programs if we are truly committed to them.

So with regard to TANF, I would love to hear your comments. With regard to freeze levels, I certainly would like to hear about this reallocation of CHIP's money that is unexpended by some States, but other States are way over utilizing some of those excess appropriations, and particularly important for my State.

Secretary THOMPSON. Let me quickly, I think you raised three things. Let me see if I can tick them off very quickly and give an answer so I do not get in trouble with the Chairman.

Senator CORZINE. I will try to protect you on that score.

Secretary THOMPSON. First on the Medicare assumptions, I would like the have a group of the Senators sit down with the actuary staff at CMS, and Rick Foster. He would like to, explain how they got those numbers, and give you their assumptions. They have gone through it with me and it is a very educational thing and I think it would be very helpful if you would have the time for them to come in and do that, Senator Corzine.

In regards to TANF I negotiated the first TANF bill with Congress when I was Chairman of the National Governors Association, and we reached an agreement of $16.4 billion and we said we would not ask for inflation if they did not cut us. And so that was the agreement back in 1995 and 1996 when we negotiated with Congress, and I was a Governor then, leading the negotiations.

Right now a lot of people would like to have an inflationary increase in the $16.5 billion base, but the caseload has been reduced by about half. And there are some people that believe that we should cut the TANF. Other people like you think we should have an inflation increase. Ben Cardin from Maryland does, and he is leading the efforts in the House for the Democrats. But other people believe we should cut it. I felt very comfortable when I sat down with the Governors and said, "If we can come out with 16.5 plus a $2 billion contingency fund, plus a supplemental fund, that we should take it and be satisfied with it." I can understand where you are coming from, but all I can tell you is that, if we can get the level funding for the TANF program, I think most of the Governors—not all, but most Governors will be somewhat happy with that, because a lot of Governors felt that they were going to be cut.

In regards to S–CHIP, I think that this is something that we should work on because if the money is not used it should be reallocated to a State like New Jersey that is doing an excellent job with their S–CHIP money and be able to use that money because it needs to get in to help children. If it is not in the budget, we should make the modifications to accomplish that.

Senator CORZINE. I think the bite on all of these issues though is going to show up in these State budgets, whether it is for just supporting the job training programs, the day care programs, all of those support programs that have been a fundamental part of the successes, if one labels them that, in the Welfare to Work, and those programs are extraordinarily expensive, and we will not have the ability.

Secretary THOMPSON. They are.

Senator CORZINE. I have one other quick question. I think I have time. One of the issues which I think you and I are probably on the same boat, although we come at it in an entirely different way, it is fairly shameful what our infant mortality rate is, what maternal mortality rate is, and Senator Bingaman and I have proposed Healthy Starts program which brings women, pregnant women themselves into the S–CHIP program. I am concerned—I will make this a statement as opposed to otherwise—that we are tying this up into political debates about abortion if this were to be proposed with regard to unborn fetuses, when in fact we ought to stay focused on making sure that we attack this infant mortality and maternal mortality problem, which I think we both agree on, and I think ends up saving us a lot of money over a long period of time.

And I do not really see why we need to get it meshed up in this other debate.

Secretary THOMPSON. If the legislation can be passed, I would agree with you, but right now I do not know if the legislation is going to get passed. And I think prenatal care for mothers is very important, as you do, and I think it is absolutely vital to have healthy children, to give them——

Senator CORZINE. You do support though, expanding S–CHIP to——

Secretary THOMPSON. I was the first one to apply for a waiver when I was a Governor, and set it up so that low-income working families could be covered. I think it is absolutely——

Senator CORZINE. I hope we could work together to find a proposal that——

Secretary THOMPSON. Absolutely.

I think you and I want to accomplish the same thing, and I would love to work with you, Senator.

Chairman CONRAD. Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman.

And welcome, Mr. Secretary. And I appreciate your testimony here today, and the focus on the President as well as yourself on some key domestic issues and priorities, and I am pleased that included in the President's budget is prescription drugs and Medicare modernization. And that is one of the areas I would like to address with you today and explore some of the issues. One, of course, is the funding issue.

Last year we included in our budget a $300 billion reserve fund for prescription drugs and Medicare modernization, and I noted the President has $190 billion. I am concerned that this obviously is not going to be sufficient to provide for a strong prescription drug program. I would like to say I think the President has $77 billion over 10 years for prescription drugs, and the remainder for Medicare modernization. Is that correct?

Secretary THOMPSON. No. The $77 million is for immediate help. This would allow a State like Maine to set up their own prescription drug program and would not have to be on Medicare, would not have to be on Medicaid. They could set up a separate program any way possible. And then the States would get their regular Federal match for drug coverage for individuals up to 100 of poverty, and then the Federal Government would come in with 90 percent FMAP for individuals between 100 and 150 percent. So the States would only be investing only 10 percent on every dollar up to 150 percent.

We think that we would use—if the Congress passes it, we would use about $7.8 billion of the $77 billion because we are hopeful that on a bipartisan basis we could modernize Medicare and have the prescription drug coverage in there so you would not need this special program at the State level. This is for years 2003, 2004, 2005, and we are hoping then by 2006, when the modernized Medicare with prescription drug would kick in, this would fall by the wayside. And during this period of time we would use 7.8 billion and the rest of it would go into Medicare, not the full 77.

Senator SNOWE. Well, that is interesting. In other words, you are saying that this money is initially for the transitional program?

Secretary THOMPSON. Yes.

Senator SNOWE. So that means that——

Secretary THOMPSON. Once you kick in the Medicare, then you would not need this program.

Senator SNOWE. Exactly, but you are still going to need additional funding for a strong prescription drug benefit program over the 10-year period, even if it is initially for this program, because this is for low-income seniors. Is that——

Secretary THOMPSON. That is correct.

Senator SNOWE. And going up to what, 150 percent of poverty?

Secretary THOMPSON. 150 percent of poverty, right.

Senator SNOWE. So, obviously, we are going to need more ultimately in order to have a strong program, even beyond the transitional program, to have to make additional funding——

Secretary THOMPSON. That is why the President put in the $190 billion over 10 years. The President and this Administration feels that we can come up with a strengthened Medicare program and have prescription drug coverage in there starting in 2006 with the $190 billion. We can argue back and forth about the $190 billion, but I think the President should be complimented in this very trying time to put in a placeholder, of $190 billion for prescription drug coverage and strengthening Medicare, and that is what we are doing.

I know that the Congress passed $300 billion last year, and I know that you are supportive of that, and I also want to compliment you on your leadership on the Medicare reform package.

Senator SNOWE. I think we are all in agreement on the common goal. The question is in terms of when to start and how we work through those issues. The President has multiple programs, which is I think significant with respect to the prescription drug benefit.

Could you elaborate on some of these issues?

Secretary THOMPSON. Sure.

Senator SNOWE. One, the President has a prescription drug discount program; is that correct?

Secretary THOMPSON. Yes.

Senator SNOWE. Second, he has a waiver program?

Secretary THOMPSON. Yes.

Senator SNOWE. Is that one of the other proposals for a State like Maine that is providing a discount prescription drug program to Medicaid recipients?

Secretary THOMPSON. Yes.

Senator SNOWE. That is another proposal. And then third is creating this transitional program?

Secretary THOMPSON. Yes, $77 billion.

Senator SNOWE. And then, fourth, obviously, would be designing the overall comprehensive program. How do you anticipate folding in the transition program to the comprehensive program? Are we hoping—is there that goal to—is it the Administration's goal to design the comprehensive program this year?

Secretary THOMPSON. I do. I hope we do it on a bipartisan basis. I think it is important for this Congress to do it, and this Administration wants to work with you. I think we can get a strengthened Medicare with prescription drug coverage passed this year if we do it on a bipartisan basis.

In regards to your question, number 1, the card. The courts put us in a temporary restraining order because we did not go through promulgating a new rule. We are in the process of promulgating the rule. We think that hopefully will satisfy the courts.

Number 2, we are asking this Congress, in the meantime, while we are working on Medicare to pass immediate helping hand for $77 billion. So that what you would do is you would, if Congress passed it, if the State would set up a program on prescription drugs like Maine has, Maine. Maine would get the regular FMAP up to 100 percent. I do not know what Maine's FMAP is. I think it is 60/40.

Senator SNOWE. That is right, just about.

Secretary THOMPSON. And so you would get 60 percent, up to 100 percent, and then from 100 to 150 you would get 90 percent coverage from the Federal Government. And this would be for a period of time until we got the Medicare up and running, and then this would go by the wayside and we would go into the Medicare coverage with prescription drugs.

The waiver program is another program that we are starting in the Department of Health and Human Services by giving a prescription drug waiver, and we have given one to the State of Illinois, and the State of Illinois is capping their Medicaid payments up to 200 percent of poverty, and they are on a sliding scale. If it goes over that, the State would pay it, and so the Federal Government is not going to be out. We are giving them a waiver to try this new program.

The fourth one is the comprehensive Medicare strengthened proposal with prescription drug coverage within it.

Senator SNOWE. Now what do you anticipate the cost of this drug subsidy program to be out of the $190 billion over, let's say, the next 3 years? What would you anticipate the cost to be out of that $190 billion?

Secretary THOMPSON. Well, we figure at least $7.8 billion for the program for up to 100 percent of poverty. We think that the model waiver for Pharmacy Plus would be held harmless because the States should cap it. We are going to set it up so they would be able to get their Medicaid match up to 200 percent of poverty, and we think that by using this, you would hold—people would be doing this and would not be spending down their assets and go into the nursing home in order to get prescription coverage.

I think we could actually save money by keeping people out of the nursing home if we set up a program like this. That is why we set up the model waiver.

The third one is the prescription drug card discount. We think we can save seniors up to a max of 20 to 25 percent of their cost if we get this general card out there through Medicare.

Senator SNOWE. OK. Well, thank you, Mr. Secretary. I applaud you and the President for leadership on these key issues. Thank you.

Secretary THOMPSON. Thank you very much, Senator Snowe.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Secretary, it is always good to have a chance to work with you, and you have been very forthright in dealing with me. I think you also know that there is strong interest in working with you on a bipartisan way. Senator Snowe and I have had bipartisan prescription drug legislation for a number of years. Senator Smith has been very involved. We want results. Today, I want to ask you some questions about some of the issues relating to the tools that we need to put together a bipartisan bill.

Let me start, if I might, with coverage for the uninsured, because your proposal this year is slightly different, but it is still pretty close to the proposal that you had in the last session, the idea of an individual tax credit of $1,000.

Tell me, if you would, what you think an uninsured person, say a woman who is 45 years old with diabetes, what is that person going to be able to buy, with the $1,000 tax credit that the Administration proposes for the uninsured?

Secretary THOMPSON. It depends upon whether or not the State would go out there and set up a pooling arrangement, Senator Wyden. I know that in our Badger Care plan back in Wisconsin, we have got a very good plan for $1,600 that would cover an individual. And in this case if the State of Oregon would set up a pooling arrangement so that this individual could go in and purchase insurance, they would go to their IRS regional office, get a number, take that number into the pooling arrangement set up by the State, either a company, a group, or whatever, and that group would then negotiate with the insurance companies to set up a policy that would cover that individual.

That would give her a fairly good policy, I would think, at $1,000. She would still have to pay probably the difference between $1,000 and $1,600 or $1,500, whatever the case may be. But I think if she is in good health, I think with the pool arrangement, she can get a fairly decent one.

Senator WYDEN. But that is the whole point, Mr. Secretary. A lot of those people are not in good health.

Secretary THOMPSON. That is true.

Senator WYDEN. Put me down as very, very skeptical. I want to submit for the record—Mr. Chairman, I was sent a letter by Ken Abramowitz of the Carlysle Group, certainly a very conservative theorist in this field. He points out that full health insurance delivered through managed care in a group setting costs about $2,500 per individual. He is not talking about a person with any special health concerns, the way so many of the uninsured have.

And I will tell you, Mr. Secretary, I am convinced that the vast majority of uninsured in this country, certainly people with any semblance of health problems, are going to get certainly 40 percent, maybe barely that, under this proposal. I hope you will work with us, because we are trying to work with a number of business groups and low-income advocates to see if we can put together a bipartisan package. I just do not think that $1,000 individual credit is going to buy anybody a whole lot, and we would like to work with you on it.

The second point that I would like to touch on deals with when we are going to get names for the key health positions in this country. The fact of the matter is we are about to spend billions of dollars in terms of bioterrorism. The 1990's were a renaissance in health policy, again, because of bipartisan work by people like Arlen Specter and John Porter.

You have got your key agencies hemorrhaging scientific talent right now at NIH, FDA. We are waiting for a Surgeon General. When do you anticipate names being sent to the United States Senate so again we can work in a bipartisan way and get these positions filled?

Secretary THOMPSON. Well, first let me back up and tell you that I do want to work with you in a bipartisan basis. As you know, you and I have worked together on many different issues, and I want to continue that opportunity, and I would look very much for that possibility.

In regards to the group policies, we have made some improvements by getting the immediate credit so that a person can apply for and get it, and the group formation is a giant step forward. So I think we can develop a good plan.

In regards to the FDA director, the President is reviewing the names that are over there, and hopefully he will make a nomination shortly, and the same way for NIH. The Surgeon General has just been opened, and we are vetting a lot of candidates. I think we have 200 applications at the present time, and the White House is going through them and going to make recommendations to me on a number of candidates. I will then interview them and get them back.

I want to tell you that I would like to have this done yesterday, and I think it needs to be done, and the President feels the same way. And so hopefully we will get those nominations to you shortly, sir.

Senator WYDEN. What is holding it up? I mean, this country cannot fight a war on bioterrorism if there are not any field generals in place. This country is filled with good scientists, people with no political axe to grind. What is your sense of why this is taking so long?

Secretary THOMPSON. We want the best person, sir.

Senator WYDEN. All right. On prescription drugs, on the issue that Olympia Snowe talked about, as you know, what the seniors are really concerned about is the cost of their medicine, and they are saying to themselves, look all over the world, and it just seems that you can go to Canada, Mexico, just about anywhere and get medicine at a cheaper price.

We really feel that the key to cost containment is to not fracture the market and to keep everybody together so they have got some bargaining power. Your proposal doesn't do that. Your proposal fractures the market. It is essentially targeted at the low-income. We all want to help them, but I am concerned about how we are going to get bargaining power for seniors in the marketplace to hold down the cost of medicine if you fracture the market.

What is your sense of how you are going to go about achieving some real bargaining power out there for the seniors?

Secretary THOMPSON. We think the prescription card put out by Medicare will be able to have a real stabilizing impact on being able to have a big bargaining chip with the pharmaceutical companies and be able to develop the necessary purchasing power to limit it.

We think that the prescription drug coverage in Medicare, if and when the Congress passes that, is going to have a lot of potential to accomplish that. But in the meantime we think it is very advisable for the State of Oregon to take a long, hard look at the $77 billion that we set aside for coverage of individuals between 100 to 150 percent of poverty with, the Federal Government paying 90 percent.

Senator WYDEN. Yes, I am willing to work with you on those various kinds of areas, but I think if you are talking about an itty-bitty discount for at least some seniors, that is not enough for cost containment. The way you get cost containment is to keep the markets together, and that is why in effect you were talking about pooling for the uninsured, and you are moving away from that in your prescription drug proposal by fracturing the market. I will work with you, but I hope you will work with us because what Olympia Snowe and I say in our bill is that the key to cost containment is to have exactly what you are talking about, pooling, and not fracturing the market.

One last question, if I might.

Secretary THOMPSON. I do want to work with you, Senator.

Senator WYDEN. I know that you do, and I appreciate it.

I would like to know your personal opinion with respect to this organ shortage situation we have in this country. As you know, it is very serious at this point. There is at present a payment ban with respect to paying for organs, essentially organs of the various sorts, live donors, cadavers, that sort of thing.

I know that this is being looked at in the Department, but I would be interested in your personal opinion with respect to, given how serious the organ shortage is in America right now, whether you personally think that the payment ban for organs ought to be lifted as a way to deal with this.

Secretary THOMPSON. Not at this point in time, Senator. I think that is something that we should continue to monitor, but I do not think we should start paying for organs. This, as you know, is a passion of mine. We have 80,000 Americans waiting for an organ, and you can imagine the angst that that individual or individuals go through with their family waiting to get an organ, when only 22,000 to 23,000 Americans are going to receive an organ this year. Sixty people receive an organ each and every day. Fifteen people die because they don't receive an organ. That is not good enough for America. We need to do a much better job publicizing, to get people out there to talk about it. I just got some TV spots with Chris Kluge, who is the skier who is in the Olympics, who got a new liver 18 months ago. He was not expected to live, and he was able now to have a liver transplant 18 months ago from a young child that was shot and killed in Denver. He got the liver and now he is performing at the Olympics. It is a powerful message that he gives out why we need to do this.

I think if we get more of these powerful messages out there and more support in Congress to pass legislation to promote organ donors, I think we can do a much better job in America and get more people involved, because every time I talk to an audience, I can convince people to sign up. I tell people, God does not want your organs in heaven, He wants your soul, and I think that is true.

Senator WYDEN. I, too, have very serious ethical reservations about lifting that payment ban. I think your answer is a thoughtful one, Mr. Secretary. I look forward to working with you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Grassley.

Senator GRASSLEY. I know you can do a very good job of defending yourself and the Administration, but I want to make a comment about three or four accusations about whether or not the President has done enough on prescription drugs.

And I say this maybe in feeling that we are working our way to doing more, and also we are saying that we have had the White House and your cooperation on helping us do those things.

But here is what is wrong with the criticism of the $190 billion at this point. For 2 or 3 years, or maybe 4 or 5 years, Congress was working on bills to get some prescription drugs for seniors and did not have the money to implement them, and all of a sudden we get $300 billion in last year's budget to implement them. And we fritter away a whole year trying to decide policy.

So instead of worrying about whether the White House is doing enough or how much money you are going to put into it, I decided the course of action we have got to take this time is to get the policy decided so that when we get the money to do it, we can jump right into it and not waste another whole year deciding what kind of policy we are going to have.

I know in your exchange with Senator Snowe you went through a lot of detail about how that ought to work out, even implementing your plan, and how you would work toward more, and how you have been working with her and with others of us to accomplish that. So that is where we have been. We should not make the mistakes of the past, and instead of worrying about whether it is $190 billion or $300 billion or what the Federal Health Employees Benefit Plan might cost if we did the same thing for seniors, I think we had better settle on policy so that when we get this economy turned around and we have got the money coming in that we can pay for the prescription drug program, we are ready to start on day one. And that is where I am going to put my energies this time.

Beyond that, I thought before I asked questions I would take just a second to thank you for the budget reflecting a lot of very important things that I think are important: obviously protection of our citizens against bioterrorism; doubling the budget for the National Institutes of Health; full funding for the Safe and Stable Families Act; transitional Medicaid assistance; community health centers; National Health Service Corps; and reducing medical errors.

Obviously I feel that the biggest flaw in Medicare today is its failure to have prescription drugs, and I believe that we need to add drug coverage this year.

You know that I have been working with a group of Senators on the Senate Finance Committee from all political persuasions to develop such a comprehensive bill to strengthen and improve Medicare, and I would hope that we could roll out a bill to do that in the very near future, and then have your reaction to that. I will not ask for that reaction now, but I know that you have been following that.

I certainly hope that we can work across party lines to accomplish this policy that I have already talked about, even though maybe the exact amount of money is not there. I believe that it would be helpful to have ideas like the Administration's transitional low-income drug benefit on the table in case we do not get the full load that I would like to get.

But in the meantime, I am going to be advocating in this Committee sufficient funds to pay for a comprehensive approach, and I think most members of my political party will follow that course of action as well.

The last thing I would like to mention before I ask any questions is just to say that another big item we have got to work on in the Senate Finance Committee, and we will have to provide for it in this budget of this Committee, is the reauthorization and change of welfare, TANF, as it is called now, and I look forward to working with you. You were a very key factor in that when you were Governor, and you know how to bring all the players together, and I hope that we will see you in the same fashion in the same cooperative way to find a solution as we did with you as Governor.

As I mentioned, one of my priorities is the prescription drug program, and I am working with a group of people to put a comprehensive program together. I hope that we will be able to have you help us with that as you have in the past.

Secretary THOMPSON. Absolutely, Senator. I would just like to comment, Senator, that your statement, the first statement in regards to Medicare and the $190 billion, spoken like a true commonsense farmer from Iowa, and I compliment you.

Senator GRASSLEY. And I suppose I also ought to remind the people of the United States that you have a farm near Eland, Wisconsin, is that right?

Secretary THOMPSON. Elroy, Wisconsin.

Senator GRASSLEY. Elroy, OK. And also then I would like to talk a little bit about rural health care. The reason I bring this up, and I think you have made clear in your statement that you are very concerned about that, but the word "rural" was never mentioned in the budget, and so I think it is important.

Do we have your commitment that if Congress spends money to strengthen and improve Medicare this year that the Administration will advocate greater payment equity for rural providers as a part of such a package?

Secretary THOMPSON. I cannot speak for the Administration, but I can certainly speak for myself and say absolutely. It is something that needs to be done. The wage question is something that causes a great deal of disparity between rural hospitals and urban hospitals. It still costs the same amount of money in Iowa as it does in North Dakota to purchase equipment in the hospital, and we need to do that.

I would like us to see if we could on a bipartisan basis, Senator Grassley, sit down with all of the providers and find out how we might be able to solve some of the formulas and do something on rural health disparity payments and see if we can improve them.

I think it would be a positive thing, and I know we have talked about it, and I know Senator Conrad is passionate about this, I know you are, and I am. I think the three of us could sit down and see what we could do in this area. I would love to work on it with you.

Senator GRASSLEY. And then maybe just a yes or no, because I think you discussed this as thoroughly as it needs to be discussed with Senator Snowe, but just the President's prescription drug program versus something more comprehensive, and I am not talking about just what I might lead a group of us putting in here shortly, but if we can develop a very comprehensive prescription drug program coupled with the improvement of Medicare, that would be the President's first choice?

Secretary THOMPSON. Absolutely. Yes.

Senator GRASSLEY. In other words, the $190 billion plan is not necessarily the President's ideal program; it is a starting point for the President.

Secretary THOMPSON. That is correct. We want to work with you, Senator.

Senator GRASSLEY. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Grassley.

Senator Stabenow.

Senator STABENOW. Well, thank you very much, Mr. Chairman, and welcome. I appreciate your leadership and advocacy on important issues like organ transplant and your advocacy for our public health system and the other wide variety of issues that are on your plate that are very important and touch people's lives.

In the interest of time I want to talk just specifically about one issue, and that is the issue of prescription drugs. It has been talked about this morning, but let me just start by saying that this is, as you know, not just an issue for our seniors, although right now we have somebody sitting at home at their kitchen table deciding do I eat today or get my medicine, pay my utility bills, tough choices that our seniors are having to make, and as tough as our choices are, I think that the choices they are having to make are even tougher.

But I am also hearing this as an issue across with everyone I talk to, small business people who see their insurance premiums going up 25, 27 percent, who call me and tell me they are canceling their insurance, they and their five employees no longer will be insured because of the cost, and it is the cost of prescription drugs. I see it from the biggest businesses in the State of Michigan coming to me who are concerned about this, university presidents who come to me, hospital CEOs who are coming to me. This is by far and away the largest underlying reason for the increase in costs of health care.

And so, on the one hand, while I believe strongly in the Medicare prescription drug plan, we need to update Medicare. It was written in 1965 and is structures like we provided health care in 1965. And I would say as an aside that when we talk about priorities for this country and in this budget, I would say that the President's first choice is not comprehensive prescription drug coverage. The first choice was the tax cut, which has taken the majority of the resources off the table, geared very much to a few at the top of the income stream, and the majority of people, seniors, small businesses, all those affected by the issue of prescription drugs, have not been the top priority. And I would like them to be, because I think this is such a pervasive issue, and the amount of money in the budget does not address in a comprehensive manner—although you have given it your best efforts, I appreciate the way you have attempted to approach this. It does not address in a comprehensive long-term manner the costs for our seniors through Medicare.

But having said that, you have within your grasp, you yourself as Secretary, the ability to cut costs immediately, substantially, and without great cost to the taxpayers of this country. And as you know, that is the issue of opening our borders to American-made, safe, FDA-approved drugs that are sold to other countries, every other country in this world, for less than they are sold here. And I know we have talked about this before, but from my perspective as we look at this budget, the tough choices, the concerns about how to design Medicare prescription drug coverage, and the time that that is going to take, and the money that that is going to take, we can at least in the short run open our borders.

As you know, the House and the Senate overwhelmingly 2 years ago passed a provision, and in fairness to you, your predecessor did not implement that. And I received a letter from you this summer, a letter from Secretary Shalala as well as yourself, concerning why you do not want to proceed with that. But I feel very strongly that if we can allow our American companies to, in fact, create manufacturing plants in other countries, if we can send FDA inspectors there to inspect them and then allow them to come back to this country, we can create a way to satisfy the concerns of the FDA and open our borders for prescription drugs. And we could at minimum cut costs by 30 percent. In efforts that I have done with Canada, it is easily 50 percent. And that would not only address seniors, it would address businesses, hospitals, universities, everyone who is concerned.

So I would appreciate your thoughts on that right now. And also when we look at your budget, you have indicated that in the budget there will be a substantial increase in the number of safety inspections for FDA-regulated products that are imported into this country. I wonder if that might not be an opportunity for us to address the issue of safety inspections in prescription drugs.

Secretary THOMPSON. First, let me thank you for your kindness, Senator. You have been very generous with your kindness to me, and I appreciate it and thank you very much.

Now second, in regards to Medicare, I really, sincerely hope that we can sit down on a bipartisan basis and develop a strengthened Medicare proposal this year. I am optimistic that we can do that and get one that is satisfactory to the Democrats and the Republicans and this Administration, and get it passed with a very comprehensive drug component. I think that we can do that, and I hope that we can do it.

Number 3, the reason that I have not, and the reason that Donna Shalala did not, is that the law requires us to certify as Secretary that we know that these drugs are safe. It is impossible for us to certify that these drugs are safe.

I came to this Committee, and I asked Senator Conrad many times to help me with food inspections. I consider this a huge problem in America, and I have said that in this Committee, in Congress, and that is why we requested some additional inspectors. We only had 700 inspectors in FDA to inspect 56,000 places. We only had 125 inspectors to inspect food that was coming into America in 151 ports of entry and we were only inspecting less than 1 percent of the food that was coming into the United States.

This Congress was very generous and on a bipartisan basis, I know you supported that as well, Senator, to give us some additional dollars. We are in the process of hiring those individuals. We are going to get an additional 400 inspectors, coupled with our 700, a little over a 50 percent increase which I think is tremendous and it is going to be very helpful.

Now if you want to pass a law requiring these inspectors to get involved in inspecting plants outside of America that are in the pharmaceutical industry, I think that is something that we should explore and see if we could not work together. But the current law in which I would have to certify that drugs coming into America are safe, I am not in a position to do that. But I think we can change the law so that we could satisfy you and satisfy your constituents and come up with something that is workable.

Senator STABENOW. I am very anxious to work with you on this because of the immediacy of the concern, both by individuals, health care providers, as well as the business Community, and the reality is that this is one of the ways to most directly and most quickly lower costs.

But let me ask, have you examined the regulatory system of Canada? Have you looked at it? Because we have taken a look at it, and feel that the system of oversight is very similar to the United States, and if we were to focus, say, just on Canada in terms of opening our northern border, I am wondering if you have looked at the regulatory and safety system.

Secretary THOMPSON. You know, the only way I can ever operate is to be candid. I personally have not, but my lawyers and people at FDA have, and they have come back with that recommendation to me that I would not be able to do that.

Senator STABENOW. Well, we are happy to change the law. I mean, in my mind that language was put in specifically to make it difficult to be implemented, unfortunately, as it went through the Congress 2 years ago, and we are going to offer something that will be much easier for you to implement and would want to work with you on that. I think it is a challenging situation. On the one hand, you have seniors that, in fact, certainly are in great pain, may lose their life as a result of inability to receive prescription drug coverage, maybe a small business whose employees find themselves in life-threatening situations because they have to stop their coverage, and we will have to weigh that as it relates to any perceived or potential risk of opening the borders.

I would argue there are risks in not opening the borders and keeping the costs as high as they are, and I look forward to working with you.

Secretary THOMPSON. The only rejoinder I would have is I compliment you on it, and I want to work with you on it. I only hope you bring the same passion to want to work with me in strengthening Medicare, and it is a two-way street.

Senator STABENOW. I absolutely want to strengthen Medicare. What I would just urge you, and I am sure that you know this, when you look at your numbers of $190 billion in terms of prescription drug coverage, it does not provide what our seniors are asking for in terms of the amount of coverage, the premium that will be unfortunately much higher than they would like. We will not be able to have 100 percent coverage. It is difficult. You cannot fit that into the box.

Secretary THOMPSON. Well, let us start.

Senator STABENOW. I am happy to start. I am happy to start and have been involved and will continue to be involved with you, because it is critically important, and probably it is the most critical issue on a daily basis for families, as well as, I think, in terms of the economy and where the uncontrollable costs are right now.

Secretary THOMPSON. Thank you very much.

Chairman CONRAD. Thank you, Senator Stabenow.

I can tell you there is nobody who has been a stronger voice for strengthening Medicare than Senator Stabenow, and we appreciate her contributions to this Committee.

I want to thank you again for your appearance here. As you know, I have high regard for you. I have high regard for you professionally and personally.

Secretary THOMPSON. I know that.

Chairman CONRAD. And I would be less than honest if I did not say I have got low regard for this budget. I do not think it adds up. I think it clearly breaks the promise that has been made to protect Social Security and Medicare. I believe that is compounded by this budget for HHS, and I know you do not have a free hand here, but I know how it works, I know the role of the OMB and the White House.

I believe this understates the cost of Medicare by $300 billion. I believe it understates the cost of a meaningful prescription drug benefit. I believe it understates the need to address payments for providers, and that is hundreds of billions of dollars of cost. So I fundamentally think it misleads Congress and misleads the American people.

My frustration is with this overall budget—not yours specifically. I have said what I see as the shortfalls there, but the overall budget circumstance is growing, as I examine more closely the overall budget, and I would send a message, if I could, through you to the Administration that I think they have put us on a fiscal course that is truly reckless. I believe that. I can see what is happening here.

You know, it used to be that budget deficits were a line in the sand, and then we were able to stop running budget deficits, and then we were able to draw a new line that fenced off Social Security funds, and that had tremendous benefits, not just to Social Security, but imposing fiscal discipline when we are on the brink of an entirely different set of facts with the demographic changes coming to this country. I believe it is absolutely essential for the fiscal future of the country to have those lines, and now the President, in not just his budget submission for this year—I could understand that at a time of economic slowdown, but he has got deficits here, budget deficits on a unified basis for years to come. He has got deficits on a non-trust fund basis for the entire next decade, and I tell you, once those lines are gone, the floodgates are open, and I can see it in the conversations I am having with my colleagues, I can see that in terms of the consideration of the other body, and it is going to take some dramatic reconfiguration.

It is very clear the tax cut imposed last year, based on an assumption of these big surpluses, that that fundamental consideration has been just dramatically changed. If we use the President's own formula, he said last year he was taking one of every four surplus dollars for tax cuts. That is how we got to $1.6 trillion out of a $5.6 trillion projected surplus. He proposed a $1.6 trillion tax cut, and he said he was taking one of every four dollars. That math did not quite work out, but that is what he was talking about.

Well, now we are talking about realistically maybe $200 or $300 billion left, really. If we take the President's proposals, we take CBO's scoring of those proposals, we have got maybe $200, $300 billion dollars left. Two or three hundred billion. And every dime of it is Social Security, every dime of it.

One quarter of that would be a $50 billion tax cut instead of a $1.6 trillion tax cut.

But the larger amount has been put into law. And the result is under the President's plan we are going to be taking $1.6 trillion of Social Security money over the next decade, $500 billion of Medicare money, and using it to pay for tax cuts and using it to pay for other spending. I think it is a profound mistake with the baby boomers about to start retiring in 6 years.

And I mean, it is not just a little mistake. I think it is a huge mistake, and the consequences for the Nation are enormous because we all know those baby boomers are going to retire, and they are going to be eligible for these benefits. And it is true the money has been credited to the accounts, but there is no money there. There are bonds there that have to be redeemed out of the future earnings, future revenue stream of the Federal Government. And that is going to compel a future Congress and a future President to propose really draconian steps, massive cuts in benefits, huge tax increases, gigantic increase in debt.

Now, I see that Senator Murray has arrived. I would certainly recognize her for a statement or questions, and be happy to have you answer as well.

Secretary THOMPSON. I just would like to thank you for your consideration and your friendship. I would like to work with you on the budget and see if we could make improvements to your satisfaction. I just want to pledge to you that cooperation, sir.

Chairman CONRAD. We look forward, as we always do, to working with you. I think you are a very creative person and a creative political leader. You certainly were in your home State and you have been here, and under very difficult circumstances.

Senator Murray, I will leave. I have an appointment here, and I will leave——

Senator MURRAY. Oh, good.

Chairman CONRAD [continuing]. You in charge.

Senator MURRAY. [presiding]. Thank you, Mr. Chairman.

I will not keep you, Mr. Secretary, and I apologize for coming late. I was Chairing another hearing, but I did want to just come, and I am sure other members have emphasized this well. But my State is really hurting. We are going to have to cut $1 billion out of a $20 billion budget. You have been a Governor. You know what that means at home. And they are very, very concerned about the Medicaid funding levels and are sending everybody here to talk to me about that. I am concerned about the budget and how we are going to address this, but I am particularly wanting to just bring to your attention today the regional inequities within the Medicaid formula that are dramatically impacting States like mine.

We have a good utilization rate and more efficient delivery structure, and we have been penalized for that. We have been trying for a number of years to try and correct that situation. I know Senator Harkin has a bill, S. 1020, that would ensure that no State get less than 95 percent of the national average Medicare reimbursement rate, but we have a severe health care crisis in the State of Washington. We have doctors and nurses who are leaving. We have a budget that is really impacted by the costs of health care that our State has had to pick up because of that low reimbursement rate.

My constituents are looking at other States that have high reimbursement rates and saying this is not fair, and so I wanted to just come and really point that out to you and see if this Administration is going to help us get a handle on that challenge.

Secretary THOMPSON. Senator Murray, I assure you that I want to work with you. I assure you that I know the problem very well from being a former Governor. I can assure you that a day does not go by that I do not receive another telephone call from a former fellow Governor of mine asking me about it. All I can tell you is that most of them are looking for increases in the FMAP, and I do not think that is going to happen, but I think the disparities certainly should be looked at.

I understand full well, you know, that you have got a health care system that pays more for utilization, whereas a State like Washington, who underutilizes and looks for ways for prevention, which I think is the way we have to go in America, is something that we should be looking at and possibly rewarding much more so than it has in the past.

All I can tell you is I will work with you and work with your Governor and work with other Governors and Congressmen and Senators to accomplish a more equitable package. There is no question in America that the health care system is strained, and we have got to make some improvements, and I have got some ideas, I know you do. I would like to sit down and see if we cannot work them out.

Senator MURRAY. I look forward to it. I am very concerned that if we do not make any adjustments to FMAP and deal with some of these problems, the number of uninsured is going to rise dramatically, and we all know that that has a huge impact on our health care system that already cannot take any more.

Thank you. Again, I apologize for being late.

Secretary THOMPSON. Thank you for coming.

Senator MURRAY. On behalf of the Chair, I will adjourn the committee.

[Whereupon, at 12:13 p.m., the committee was adjourned.]

PREPARED STATEMENT OF SENATOR RUSS FEINGOLD

Thank you, Mr. Chairman, for holding this hearing today. I would also like to thank my friend and former Governor, Secretary Thompson, for testifying here today. I want to commend him for the job he has done as Secretary. While we may not always agree on every policy, his straightforward management of so many vital Federal programs is a welcome breath of fresh air in Washington.

The Department of Health and Human Services' budget contains some of the most vital programs to Wisconsinites, from Medicare to our health care safety net to research programs that can find cures for diseases like Alzheimer's and Diabetes.

I want to commend the Administration for doubling funding for the National Institutes of Health by providing the final installment of $3.9 billion over the Fiscal Year 2002 funding level. This research is of paramount importance to this and future generations.

I also strongly support the Administration's proposal to strengthen our health care safety net. While I would like to see the safety net improved beyond what the President has proposed, I commend him for attempting to address the health care work force shortage by increasing funding for the national health services corps and the Nursing Education Loan Repayment Program.

I was joined by my colleague from Arkansas, Senator Hutchinson, last year in promoting the Nurse Education Loan Repayment Program, and I am glad to see that the President also considers this program a priority.

I must express my concern, however, at the lack of emphasis to address Medicare modernization, including the addition of a prescription drug benefit.

The additional Medicare funding in the President's budget does not take us in the direction of real reform. For example, the President's budget has a 6.5 percent increase in the HMO rate for the Medicare+Choice Programs, even though this program isn't available to Medicare recipients in much of the country.

Medicare HMOs aren't offered in the vast majority of Wisconsin counties, so we would receive little, if any of the benefits from this additional funding. Instead of expanding access to this program, this funding would subsidize existing Medicare HMOs in other parts of the country to offer benefits such as eye glasses and hearing aids. I strongly favor offering these benefits under Medicare, but they should be provided to *all* beneficiaries regardless of where they live.

While the President's proposal to include $190 billion for targeted improvements and comprehensive Medicare modernization is a good first step, it is not adequate to provide an effective prescription drng benefit or other necessary modernizations.

I am also concerned that across-the-board cuts may jeopardize access to health care for Wisconsin Medicare beneficiaries. Just last year, due to a glitch in the Medicare payment formula for physician services, as of January 1 of this year, a 5.4 percent Medicare cut affects all Medicare services provided by physicians and other health professionals.

These cuts in Medicare dollars to providers have devastating consequences, particularly for states like Wisconsin where Medicare payments are already low. The cut will force providers in my state to make difficult choices concerning their ability to accept new Medicare patients, opt out of the Medicare program, lay off administrative staff or retire early.

I recognize the budget constraints that we face. And while I disagree with the President about how we arrived at this budget situation, I strongly agree with him that we must reign in wasteful Federal spending to fund important priorities such as Medicare. And when we need to evaluate our funding priorities, Medicare should be at the top of the list. We need to look within the Federal budget and allocate more funds for this important program if we are serious about modernizing Medicare.

Again, I would like to commend the Secretary for all of his efforts to reform the Department and make it more effective. Our Federal Government is truly fortunate to have such an effective and dedicated public servant. I look forward to working with him and the Administration during this next budget cycle to make sure the budget lives within its means and, at the same time, supports important priorities like the Medicare program.

PREPARED STATEMENT OF SENATOR OLYMPIA SNOWE

Good morning. I would like to express my appreciation to the Chairman and Ranking Member for holding this hearing on the President's budget proposals for programs under the Department of Health and Human Services. And, I join with my colleagues in welcoming Secretary Tommy Thompson. Mr. Secretary, thank you for being here with us today.

The President's budget is an ambitious blueprint that proposes to enhance our bioterrorism preparedness, reduce the number of uninsured Americans, provide prescription drug coverage for seniors, modernize Medicare, and speed the approval of lower-cost generic drugs—all while we continue to fight the war on terrorism. The President is to be commended for maintaining his focus on the domestic front—on important issues like Medicare, medical research, and the economy—while our country is engaged in efforts to defeat those who would do harm do our citizens and our country.

One of the most important domestic priorities is modernizing Medicare and providing a drug benefit for our Nation's seniors. Senator Grassley and I worked together last year expand the funding in the congressional budget resolution for Medicare and prescription drugs to $300 billion. That the President proposed only $190 billion for this important priority was a disappointment. This year, I hope we can again have at least $300 billion designated to modernize Medicare and provide seniors with prescription drug coverage. Since last July, I have been working with Senators Grassley, Hatch, Jeffords and Breaux, and together we have developed a tripartisan approach to modernizing Medicare and creating a drug benefit. We think there is momentum for moving forward, and with the President's strong support and appropriate funding in the budget resolution, we can get this done this year.

The President has also renewed the debate over how to help the uninsured obtain affordable health care. Last year, Congress set aside $28 billion for efforts to lower the number of uninsured in our country—a sum that we knew to be inadequate to the task. This year, the President has proposed an $89 billion package of tax credits plus increased funding for community health centers and the National Health Service Corps. Bipartisan action is necessary, and I applaud the President for his leadership.

Another issue that has long been a passion of mine is the unique health needs of women. We have come a long way from the days when women were excluded entirely from clinical trials. However, there is much left to be done. Mr. Secretary, I hope to work with you in the coming months to complete a long-term goal of mine to permanently authorize Offices of Women's Health within agencies of your Department, including the FDA, CDC, the Agency for Health Care Research and Quality and the Health Resources and Services Administration, The establishment of these offices will go a long way towards ensuring that women's unique health needs are identified and met throughout our nation s public health system—goals that I believe both you and the President are committed to.

On welfare reform, as you know firsthand from your experience and leadership on this issue, the 1996 reform changed welfare from a way of life under the old entitlement system, to a temporary assistance program, focused on work and self-sufficiency. We have witnessed dramatic decreases in welfare caseloads—decreases more dramatic than any of us may have dared to hope for.

However, as with any reauthorization, it is critical that we take a close look at the shortcomings, as well as the successes, of the 1996 effort, before we reauthorize the program. Careful consideration of the rules governing work supports like child care subsidies, assignment of child support payments, and access to transitional benefits like food stamps and Medicaid, will significantly effect whether a family succeeds in making a successful transition from welfare to work. Overall, I believe that the 1996 effort was a landmark effort, however, there are areas in need of improvement that are critical to the future well-being of our Nation's most vulnerable families. I look forward to working with you, to reauthorize the 1996 welfare reform bill. Your experience in this regard will be of tremendous value as the Congress begins this endeavor.

Thank you Secretary Thompson for appearing before us today and I look forward to hearing your testimony and working with you in the coming months on these issues many of which are priorities for this committee, the Senate and the Nation.

WRITTEN QUESTIONS FROM CHAIRMAN CONRAD TO SECRETARY THOMPSON AND THE RESPONSES

Question: As you know, the President's budget would provide Medicare+Choice plans $4.1 billion in additional resources over the coming years. While it is certainly important to ensure Medicare beneficiaries served by Medicare+Choice plans have access to stable and quality care, I am concerned that the President's budget does not reflect a similar commitment to the more than 86 percent of Medicare beneficiaries who are enrolled in traditional Medicare fee-for-service.

According to recent Medicare Payment Advisory Commission recommendations, many health providers who serve fee-for-service beneficiaries, including rural hospitals, home health agencies, physicians and other providers, are in need of increased Medicare reimbursement. However, there are no additional resources allocated in the President's budget to meet this need. In addition, we have witnessed increasing Medicare+Choice plan withdrawals, which have totaled more than 170 over the last few years and have affected more than 2.2 million seniors. Finally, in North Dakota any many other States with primarily rural populations, there has been minimal availability of Medicare+Choice plans, which means that an investment in this program will likely have no positive impact for beneficiaries living in these communities.

Given the clear need to provide additional resources to fee-for-service providers, particularly those serving rural communities, I would be interested in hearing your views on how the Administration would propose meeting these needs within the President's Fiscal Year 2003 budget request.

Answer: The Administration shares your commitment to ensuring that all our Nation's elderly and disabled have secure access to modern health care whether they live in New York City or Grand Forks, North Dakota. The President's fiscal year 2003 budget renews his commitment to comprehensive Medicare modernization integrated with prescription drug coverage. This proposal is based on the framework for bipartisan legislation that he proposed last July. Specifically, the President's budget proposes to invest $190 billion in Medicare to modernize the program by improving health insurance plan options for all beneficiaries that include prescription drug coverage. The President's budget did not contemplate any particular provider payment changes; however, the Administration is willing to work with Congress to consider limited adjustments to payment systems and to work to develop a comprehensive package that is budget neutral across providers. As we consider changes to payment systems, we must be cautious; our focus remains on beneficiaries and how best we can spend Medicare dollars to ensure seniors have access to quality care, including the availability of reliable private plan options.

WRITTEN QUESTIONS FROM SENATOR FEINGOLD TO SECRETARY FEINGOLD TO SECRETARY THOMPSON AND THE RESPONSES

Question: As you know, I am concerned about many of the inequalities in the Medicare program, and that due to the use of inaccurate data, reimbursement rates in Wisconsin are some of the lowest in the country. One section of the Medicare, Medicaid and SCHIP Benefits Improvement and Protection Act of 2000 requires the Secretary of Health and Human Services to collect data every three years on the occupational mix of hospital employees for the purposes of constructing an occupational mix adjustment to the wage index for use beginning in Fiscal Year 2005. Given the importance of the wage index in adjusting hospital payment levels across geographic areas, any changes to the current system should be carefully considered. What is the status of this proposal? Do you plan to issue a detailed proposed methodology, for comment, illustrating how the occupational mix index will be calculated and how it will be used to adjust the overall wage index?

Answer: I share your desire that the Medicare program treat all beneficiaries equitably and am committed to ensuring that Medicare payments, and the data used to calculate them, are appropriate. As you stated, the Benefits Improvement Protection Act requires the Secretary to collect data on hospitals occupational mix by September 30, 2003, for use beginning in Fiscal Year 2005. We are currently on track to meet this deadline, and we are developing the methodology and the process by which the methodology will be implemented.

Question: One other area of concern is the substantial variation in payments to skilled nursing facilities. As you know, payments to skilled nursing facilities are currently geographically adjusted using the hospital area wage index. Skilled nursing facilities employ a significantly different group of health professionals than do hospitals. And using this geographic adjustment results in misguided geographic variation in payments to skilled nursing facility. My understanding is that the Center for Medicare and Medicaid Services is already collecting skilled nursing facility wage data, but has not set a date for implementation. When can we expect a formal rule on using skilled nursing wage data to geographically adjust payment rates to skilled nursing facilities?

Answer: CMS has been collecting data nationally for several years on skilled nursing facility wages. On May 10, 2001 (*66 FR 23984*), we published a proposed rule that included the results of CMS' analysis of this data. Unfortunately, CMS found there were problems with the data's accuracy and reliability. As a result, CMS is continuing to study this issue, as well as whether committing the significant resources we believe will be required by providers and contractors to improve this data, is appropriate and will, in the end, provide some commensurate level of improvement in the accuracy of SNF payments. Until this decision is made, we continue to believe that the current hospital wage index provides the best available measure of geographic variation in wages in this sector.

Question: The Balanced Budget Act of 1997 mandated a balance between urban and rural representatives on the Medicare Payment Advisory Committee, but there seems to be little progress in ensuring adequate rural representation. I understand that five rural candidates have been submitted to the General Accounting Office which makes the formal recommendations. Do you see any future progress in ensuring adequate rural representation?

Answer: I certainly hope so. As your question clearly recognizes, MedPAC is an independent Federal body, and its members are appointed by the General Accounting Office, not the Department of Health and Human Services. Thus, while I do not have the authority to determine appointments to MedPAC, I am doing what I can to ensure that rural health issues are at the forefront of this Administration's health care agenda. I believe the HHS Department-wide Rural Health Task Force that I convened is one example of the sincerity of my commitment to rural health issues.

Question: I would appreciate it if you could address an issue of great concern to the providers in my State of Wisconsin, the Medicare physician payment update formula. The Medicare Payment Advisory Committee (MedPAC) has urged that this formula, which is used in the Medicare program to reimburse physicians, nurses, therapists and many other providers, does not adequately address the cost of care. On January 1st of this year, these providers received the largest cut to their reimbursement in the history of the Medicare payment system. These cuts in Medicare dollars to providers have devastating consequences, particularly in States like Wisconsin, where Medicare payments are already some of the lowest in the country. The cut will force providers in my State to make difficult choices concerning their ability to accept new Medicare patients, opt out of the Medicare program, lay off administrative staff or retire early. Having said this, it is clear that the current Medicare payment cut will likely result in patients having difficulty finding a physician and other health care providers. What is the Administration's position on creating a new system that appropriately reflects the relevant factors in practice costs that MedPAC recommended?

Answer: The current system for updating Medicare's payment for physician services was originally established in law in 1989, and has been adjusted a number of times since then, eventually resulting in the Sustainable Growth Rate (SGR) system that is used today. The system has been working as designed with physician spending increasing from 17.6 percent to 20.5 percent of total Medicare fee for service spending between 1997 and 2001. Last year, a number of factors combined to cause the physician payment formula, as set in law, to produce a negative update. However, despite the negative update, overall Medicare physician spending is not projected to decrease this year.

We believe that considerations of sustainability and of our other urgent priorities in Medicare argue strongly that, if changes in the physician payment system are undertaken this year, they should be undertaken carefully and implemented in a way that does not significantly worsen Medicare's long-term budgetary outlook. The Administration supports reforms in physician payment that lessen volatility, and further believes that any short-term payment problems can be addressed at a much lower cost that the MedPAC recommendation implies.

WRITTEN QUESTIONS FROM SENATOR NELSON TO SECRETARY THOMPSON AND THE RESPONSES

Question: Do you know why the Center for Medicare and Medicaid Services has not yet approved Florida's Upper Payment Limit (UPL) plan amendment? I understand that it has been pending at CMS for quite some time?

Answer: CMS approved Florida's LTPL amendment on February 22nd CMS had requested additional information from the State in order to complete their review of the amendment. The State provided that information in mid February. Once CMS received the information from the State the Agency was able to complete its evaluation of the plan and approve the amendment.

Question: Regarding the CMS rule, scheduled to take effect March 19, to eliminate the Medicaid 150 percent UPL: Why has CMS chosen to take an ax to a vital Federal program that is working well in many States to provide care to those most in need? If some States have abused the program, why not go after the "bad actors" rather than curtailing the flow of $9 billion in Medicaid funds over 5 years?

Answer: Some States have used a variety of legal and regulatory loopholes to enhance the Federal funds that they receive to help provide health care for their citizens. Although States often have worthy reasons for using these loopholes, this is not how the Medicaid program was designed. CMS believes that it is important to ensure that all beneficiaries get the care they are entitled to and that the Federal Government pays its appropriate share under the law. However, if States are not providing their appropriate share of the expenditures, and if these Federal funds are not used to pay for Medicaid covered services provided to Medicaid-eligible individuals, CMS has a duty to correct the situation.

Federal statute and regulation restrict Medicaid spending to Medicaid eligible services, populations, and providers. While some States are using this money to pay for laudable, health care related services, if the services or the people receiving them are not covered under the Medicaid statute, it is inappropriate for this money to be used to pay for the services. Even when States use UPL money to pay for Medicaid services for Medicaid eligible citizens, the financing arrangements are still a problem. Because the money is recycled through State treasuries, there are little or no real State matching dollars. The Department's IG and the independent GAO believe these UPL payment arrangements violate both the letter and the spirit of the Medicaid laws.

WRITTEN QUESTIONS FROM SENATOR SMITH TO SECRETARY THOMPSON AND THE RESPONSES

Question: Yesterday, I sent a letter to President Bush articulating this priority, and urging him to work with Congress this year on a realistic plan to cover the uninsured. I have also met with Tom Scully to discuss ideas for covering the uninsured. And I would like to ask you, Secretary Thompson, on this day—Valentine's Day—would this Administration be willing to work with the Congress in crafting comprehensive uninsured legislation that would provide not only health credits and deductions, but appropriately targeted program expansions as well?

Answer: The Secretary looks forward to working with Congress to enact legislation that will improve access to affordable health care coverage insurance. The legislative package proposed by the President would commit over $117 billion and provides a comprehensive vision to improve accessibility and affordability of Health care for all Americans. Its emphasis is on empowering individuals to make their own choices. The plan also acknowledges an important role for public programs, which the President wants to improve.

The President's plan would improve public programs and their ability to cover more of the currently uninsured by:

- Continuing Medicaid funding for Americans in transition from welfare to work ($350 million).
- Working with States to develop coverage innovations without increasing spending.
- Making available to States an estimated $3.2 billion in unused S–CHIP funds that would otherwise be lost.

Since January 2001 there have been 1.8 million new people covered under these Medicaid program and beneficiaries are receiving 4.5 million new benefits. These proposals complement other components of the President's plan to expand and improve private sector health care coverage by:

- Offering refundable tax credits of up to $3000 for families without employer-sponsored insurance to help them pay for their insurance premiums. The Administration will work with States to expand State-sponsored purchasing pools, which will further ensure that these families have access to affordable insurance options.
- Lifting excessive restrictions on Medical Savings Accounts (MSAs) and Flexible Savings Accounts (FSAs).
- Making it easier for small employers to pool together to offer their employees health insurance comparable to insurance offered by large employers.

Question: The President's budget suggests that States should be given more flexibility to develop innovating approaches to Medicaid and S–CHIP without seeking Federal waivers. Could you describe in a bit more detail what the Administration has in mind?

Answer: In August 2001, the Administration announced the Health Insurance Flexibility and Accountability (HIFA) Demonstration Initiative. The HIFA Initiative:

- Gives States the flexibility to develop comprehensive health insurance approaches that utilize available Medicaid and SCHIP funding to address insurance coverage for individuals with incomes less than twice the official poverty level, who comprise most of the uninsured.

- Gives States the flexibility to increase health insurance coverage through support of private health coverage.
- Simplifies the waiver process by providing clear guidance and data templates.
- Increases accountability within the State and Federal partnership by ensuring that Medicaid and SCHIP funds are being effectively used to increase health insurance coverage.

The Administration will continue to build on the HIFA Initiative by developing proposals to give States the statutory authority to provide broader coverage to low-income Americans and the flexibility to design innovative programs without seeking waivers. States will be encouraged to use current resources to extend coverage to their neediest residents and reduce the number of people without health insurance coverage. These proposals are currently under development and I look forward to working with Congress as we continue to look for innovatice approaches ro incease health insurance coverage.

Question: Mr. Secretary, research seems to indicate that people leaving welfare often have difficulty obtaining health insurance. It may be that, because they are employed, they are no longer eligible for Medicaid, and their employers do not offer heahh insurance. It may also be that they are offered employer-based coverage but cannot afford their share of the premium. I also understand that people leaving welfare may still be eligible for government coverage but do not know it. Are you confident that we are doing enough to make sure that people leaving welfare have access to health coverage, or is this an issue we should address during the upcoming reauthorization of welfare?

Answer: As a former governor, I can tell you that the Temporary Assistance for Needy Families Program—or TANF—has been a truly remarkable example of a successful Federal-State partnership. States were given tremendous flexibility to reform their welfare programs and as a result, millions of families have been able to end their dependency on welfare and achieve self-sufficiency. But even with this notable progress, much remains to be done, and States still face many challenges. You raise an important point about access to health coverage after leaving welfare and we need to be sure that we address this during the upcoming reauthorization of welfare.

The law enacting TANF recognized the importance of providing health care to encourage and ensure the success of families making the transition from welfare to work. That law required States to continue transitional Medicaid assistance for up to one year to families who would otherwise lose it due to work. Some innovative States provide transitional access to Medicaid for even longer periods of time.

I understand that perhaps not all families eligible for such transitional coverage may have received it. However, I can assure you that everyone at the Federal and State level recognizes the value of health coverage as an incentive to work and further, that both levels of government are committed to remedying any administrative shortcomings in the program.

Finally, I would note that the transitional Medicaid assistance is scheduled to sunset on September 30, 2002. The President proposes to spend $350 million to extend the transitional Medicaid assistance an additional year. I have asked my staff to look for ways to further improve the long-term effectiveness of Medicaid for families in transition to work. I look forward to working with the committee on reauthorization of this hallmark program.

Question: Mr. Secretary, I have been a major proponent of a real prescription drug benefit for seniors, working with my colleagues in this committee last year to set aside $300 million for prescription drug coverage. I was encouraged to see that the President agrees with Congress that prescription drug coverage for seniors is a high priority. But his budget proposes allocating only $190 billion for prescription drug coverage and Medicare reform, while at the same time calling for a "comprehensive reform plan that includes prescription drugs for every senior." Of the $190 billion proposed by the President, $77 billion is to go to the states to expand drug coverage for low-income seniors. The Administration anticipates that the States may run these programs through Medicaid. I am worried, Mr. Secretary, that the proposed $190 billion is far too small to provide a meaningful benefit to struggling seniors, and that relying on State Medicaid programs will have an adverse impact on the non-elderly uninsured. Mr. Secretary, can you describe for me what kind of benefit you realistically anticipate being able to provide to our Nation's seniors for $190 billion?

Answer: The Fiscal Year 2003 budget dedicates $190 billion over ten years for immediate targeted improvements and comprehensive Medicare modernization, including a subsidized prescription drug benefit, better insurance protection, and better private options for all beneficiaries. The President's proposal for assistance for low-income drug coverage reflects the fact that all of the major drug benefit proposals that Congress will be debating—all proposals from Republicans and Democrats alike—include new Federal support for comprehensive coverage of seniors up to 150 percent of poverty. And in all the proposals, the Federal Government would work with the States to provide this coverage.

The Medicare transitional low-income drug assistance program is one of the steps that Congress can take now to assist low-income seniors while a comprehensive drug benefit for all seniors is developed. The President intends that a comprehensive benefit for all seniors would be in place by 2006, and would spend $8 billion over the next three years for the transitional assistance program. If comprehensive reform, including a subsidized drug benefit for all seniors, is not enacted by 2006, then the Medicare transitional low-income drug assistance program would continue until a comprehensive benefit is enacted. If the transitional program were to continue for a full 10 years because a comprehensive benefit had not been enacted, then the full cost of the transitional program would be $77 billion.

The transitional low-income assistance program will provide States with funds to establish drug only programs for seniors up to 100 percent of poverty at existing Medicaid matching rates and would provide a 90 percent Federal match for the costs of these programs for seniors between 100 and 150 percent of poverty—about $17,000 for a family of two. This policy would eventually expand drug coverage for up to 3 million beneficiaries who currently do not have prescription drug assistance.

Last year, the President proposed the creation of a new Medicare-endorsed prescription drug card program to reduce the cost of prescription drugs for seniors. This year, HHS will continue working to implement the drug card, which will give beneficiaries immediate access to manufacturer discounts on their medicines and other valuable pharmacy services. The President is absolutely committed to providing immediate assistance to seniors who currently have to pay for prescription drugs.

In addition, I recently announced a model drug waiver program—Pharmacy Plus—to allow States to reduce drug expenditures for seniors and certain individuals with disabilities with family incomes up to 200 percent of the federal poverty level. This program is being done administratively. The first such program was approved in January 2002 for the State of Illinois. The Illinois initiative illustrates how we can expand coverage to Medicare beneficiaries in partnership with the Federal Government. The program we approved will give an estimated 368,000 low-income seniors new drug coverage. The model application I have announced is easy to understand and use, and the Centers for Medicare and Medicaid Services is working with numerous States—at least 12—that have already expressed interest in this program.

Question: Mr. Secretary, can you tell me, if Oregon were to run a prescription drug plan for low-income seniors as envisioned under the President's proposal, what kind of expenditures you would expect the State to incur? I ask you to keep in mind that our Medicaid Program—the Oregon Health Plan—is already in financial difficulties as the State struggles with more Medicaid-eligible uninsured people, while the State is experiencing serious deficits?

Answer: Unfortunately, CMS is not able to formulate State-specific cost estimates for expanded drug coverage. Many States have already begun exploring ways to expand drug coverage to low-income seniors through State-only funded drug assistance programs and Medicaid expansions. The President's new proposal will give States the Federal support and flexibility they need to provide prescription drug assistance for low-income seniors in conjunction with the implementation of a Medicare drug benefit. For seniors with incomes between 100 and 150 percent of the Federal poverty level, the Federal Government will contribute 90 cents of every dollar spent by States.

The Administration believes that States understand the benefit of providing some drug coverage to low-income Medicare beneficiaries. By paying a few dollars up front for drug coverage, States may possibly avert impoverishment or long-term disability of seniors that can lead to higher Medicaid costs for States in the long run.

Question: As you may know, current cost trends for some Medicare+Choice providers in Oregon are running between 10–15 percent. The Administration has proposed a 6.5 percent increase for the Medicare+Choice Program. This is a step in the right direction, however, how can CMS implement a Medicare+Choice increase that is relative to what the jurisdictions are already receiving, so that no county receives a greater proportion? Otherwise, under-reimbursed counties in States such as Oregon won't benefit. Further, what is the Administration's plan in general to address regional disparities in Medicare+Choice reimbursements so seniors in Oregon can have greater benefits and reduced premiums in line with what seniors in other "higher" reimbursement areas are currently getting?

Answer: Since the Medicare+Choice payment changes, included in the Balanced Budget Act of 1997, went into effect in 1998, the rates of increase in

Medicare+Choice payments have varied significantly from county to county. Many Medicare+Choice enrollees live in counties where the rate increases since 1997 are less than 12 percent. Others live in counties where the rate of increase has been much higher. For example, I understand that rate increases in some Oregon counties with substantial Medicare+Choice enrollment have ranged from about 35 percent to over 70 percent since 1997.

The immediate issue facing us right now is to address payment rates in counties where rate increases have generally been only 2 or 3 percent a year. We want to work with the Congress to address this important payment change for 2003, and we also want to work with Congress on broader Medicare Program improvements, including examining payment inequities, such as those you describe, and looking at new ways to set payment rates under the Medicare+Choice Program as a whole.

Question: Secretary Thompson, MedPAC and the American Medical Association, both agree that the Medicare formula to reimburse physicians, nurses, therapists—and just about everyone else who treats Medicare patients—is highly flawed. As of January 1, physicians have received their largest cut in the history of the Medicare payment system. Cuts in Medicare dollars to providers have devastating consequences, especially in rural States such as Oregon. Most Medicare providers are small businessmen and women—in fact, two-thirds of physicians offices in Oregon and throughout the country meet the definition of a small business. Cuts in revenue to these small businesses inevitably means that physicians and other providers will discontinue seeing Medicare patients, retire early, lay off staff, or postpone necessary investments in new technology. Clearly this has profound implications for access to health care. A recent survey by the American Academy of Family Physicians found that nearly 30 percent of family physicians are not accepting new Medicare patients. I find this very troubling. Oregon physicians alone will lose nearly $15 million dollars this year because of the cut. A super-majority of the Senate supports funding to alleviate some of the harm from these cuts. (69 Senators have cosponsored S. 1707, the Medicare Physician Payment Fairness Act, which CBO recognizes as an item that will be scored). Mr. Secretary, I hope you will also support a budgetary proposal to fix this critical health care problem. Secretary Thompson, this issue must be addressed. The President, in his budget, referenced the problem, but said it must be resolved in a budget-neutral way. If Medicare reimbursement payments are taking this major cut, how can fixing the formula occur in a budget-neutral manner?

Answer: The current system for updating Medicare's payment for physician services was originally established in law in 1989, and has been adjusted a number of times since then, eventually resulting in the Sustainable Growth Rate (SGR) System that is used today. The system has been working as designed with physician spending increasing from 17.6 percent to 20.5 percent of total Medicare fee for service spending between 1997 and 2001. Last year, a number of factors combined to cause the physician payment formula, as set in law, to produce a negative update. However, despite the negative update, overall Medicare physician spending is not projected to decrease this year.

While the President's Budget did not contemplate any particular provider payment changes, we are willing to consider limited adjustments to payment systems and to work with Congress to develop a comprehensive package that is budget neutral across providers. We will not support any package of provider payment changes unless it is budget neutral in the short and long term. To this end, we recognize that some provisions in law that, in the past, have restrained growth in payments are about to expire, and extension of these provisions is one potential way to ensure a budget neutral package or reforms.

WRITTEN QUESTIONS FROM SENATOR HOLLINGS TO SECRETARY THOMPSON AND THE RESPONSES

Question: "While our Nation is focused on the war in Afghanistan, bioterrorism, and homeland security, which I and all of us on the Committee fully support, how will we meet the demands of chronic disease in our Nation without increased funding for the chronic disease prevention and control programs at the CDC?"

Answer: HHS remains committed to reducing the burden of chronic diseases. To that extent, I have directed the Department to begin formulating a comprehensive prevention strategy with CDC playing a major role. Much of what we know about prevention and management of chronic diseases comes from our research, and the budget includes substantial funds for prevention research at the National Institutes of Health.

The CDC's Fiscal Year 2003 funding of $697 million reflects program increases totaling $14 million and a reduction of $71 million in program and management savings. Most activities, including tobacco, diabetes and arthritis prevention, are funded at essentially the same level as last year. There are nominal reductions targeted at internal CDC management improvements.

The Fiscal Year 2003 funding includes increases of $14 million in cancer prevention and health promotion activities for,

- *Breast and Cervical Cancer Screening*: $203 million, an increase of +$9 million, to provide 29,000 mlore mammographies and pap smears; and
- *Healthy Communities*: $5 million for a new public education campaign to promote exercise and physical activity, with a focus on families.

The $71 million in program and administrative savings in the Fiscal Year 2003 funding reductions are for discontinuing the Youth Media Campaign (a savings of $68 million) and management reforms that reflect consolidation of certain job functions and workplace restructuring (a savings of $3 million). With regard to the Youth Media Campaign, we note that:

- Congress reduced this program in Fiscal Year 2002 from $125 million to $68 million;
- The Fiscal Year 2003 budget proposes eliminating the remaining funds;
- Because the initial projects planned for this major media activity have not yet begun, we are hesitant to invest future resources until there is a full assessment of the benefit and effectiveness of this approach; and
- The paid advertising campaign will begin in May 2002; Campaign events in fifteen cities will begin in October 2002.

Question: "Mr. Secretary, TANF reauthorization and welfare reform is one of the major issues the Senate and your agency will have to address this year. I believe your experiences and record in this area as Governor will prove a valuable asset during the debate. At the same time, I think it is important to note that not every Governor is afforded the same opportunities that you were. I still remember what you said last year during your confirmation hearing that welfare reform "can't be done on the cheap", yet that is what the current law expects many of our States to do—welfare reform on the cheap.

"To the point, you received more than three times the TANF funding per poor person than my Governor received. I would challenge anyone to prove that welfare recipients are three times as poor in Wisconsin as they are in South Carolina. Mr. Secretary, do you feel that [sic] is fair and just for States like South Carolina to receive a fraction of the TANF funding than [sic] States like Wisconsin, New York, California, and Connecticut receive?"

Answer: As Congress enacted the welfare reform legislation, the TANF block grant amount for each State was based on the highest Federal dollars it received for the AFDC, Emergency Assistance, Job Opportunities and Basic Skills (JOBS) and related child care programs in FYs 1992–1994 (annual average), FY 1994 (adjusted), or FY 1995 (estimated). This funding distribution among States closely relates to the spending patterns that States 1exercised under the former, matching AFDC program, because these benefits largely dwarf other prior program funding.

Under AFDC, in FY1994 State expenditures for benefits were Federally matched from 50 to 79 percent, based on the inverse ratio of average per capita income of a State. To illustrate, in that year, South Carolina had a matching rate of 71.08 percent, Wisconsin's was 60.47 percent and New York, California and Connecticut were all matched at 50 percent. Stated differently, for each dollar of State investment in FY 1994, South Carolina received $2.46, Wisconsin received $1.53 and the others each received one Federal dollar. By providing a higher match rate, the formula attempted to compensate for a reduced ability of low per capita income States to raise funds.

But, as you have noted, the differential matching rate did not eliminate the historical disparity in State spending per eligible child. Under the funding formula designed by Congress and widely supported by Governors, the prior, disparate spending pattern of each State determines the amount of the annual block grant.

Congress made an effort to address these disparities in funding per poor child among States through supplemental grants to States that had both substantial population growth *and* low per capita welfare spending. $800 million was available for fiscal years 1998 through 2001. But, South Carolina failed to qualify for supplemental grant funding.

In our reauthorization listening sessions with States and in response to our request for written comments, there were very few comments recommending a change in the current funding formula. Both our budget and the President's recently released welfare reform proposal retains the existing block grant formula and asks Congress to restore and fund supplemental grants at $319 million annually. We want to work closely with you and other Members on the reauthorization to promote work and strengthen families working toward independence.

WRITTEN QUESTIONS FROM SENATOR SARBANES TO SECRETARY THOMPSON AND THE RESPONSES

Question: What are your views on the importance of the FDA consolidation and the Administration's commitment to this project?

Answer: FDA consolidation at the White Oak, Maryland site remains a high priority for the Administration. FDA Headquarters currently occupies approximately 39 buildings in more than 16 locations. It is important for an Agency, entrusted with protecting the Nation's food supply and approving pharmaceuticals, biologic products and medical devices, to have modern facilities and be able to work effectively and efficiently.

Assistant Secretary for Administration and Management, Edward Sontag, has already attended one of the local community's Labquest meetings at White Oak and has seen first hand the local support the FDA consolidation project has gained. Hopefully, any further delays to this important project can be minimized.

Question: FDA's Fiscal Year 2003 budget justification includes $159 million for counter terrorism which would fund almost 900 new employees. I am advised that for those assigned to the Washington area, one possibility for housing them would be to quickly renovate the existing main building at White Oak, which was formerly the Navy headquarters building. If funds could be made available for that purpose, would HHS support such an initiative?

Answer: We understand from GSA, that in the revised master plan for White Oak, Building One (the existing main building) takes on a more prominent role. Building One has been designated as the "front door" of the FDA campus. This structure would be revitalized and an architectural forecourt, consisting of two flanking buildings and a circular pedestrian plaza, would be established. Providing funds for Building One's renovation would be beneficial to the long-term development of the site, and could accommodate increased review staff and new counter terrorism personnel being employed by FDA's Center for Drug Evaluation and Research. The new FDA counter terrorism employees are spread among the headquarters organizations and the Office of Regulatory Affairs; therefore co-locating all of these new employees in a single building may not be the most efficient deployment of these personnel.

THE EFFECTS OF THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSAL ON THE ARMY CORPS OF ENGINEERS, THE FEDERAL HIGHWAY ADMINISTRATION, AND THE DEPARTMENT OF EDUCATION

TUESDAY, FEBRUARY 26, 2002

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

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

Present: Senators Conrad, Murray, Domenici, and Bond.

Staff Present: Mary Ann Naylor, staff director; Bonnie Galvin, analyst; Sarah Kuehl, analyst; and Shelley Amdur, senior analyst.

For the minority: G. William Hoagland, staff director; Margaret Stewart, senior analyst; James O'Keeffe, senior analyst; and Walter Hearne, junior analyst.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The committee will come to order.

We want to welcome the witnesses who are here with us today to share their expertise. Today we are going to look at the President's budget and its impact on three major areas of the Federal Government: highway and bridge-building programs, the construction projects of the Corps of Engineers, and education.

We have two panels this morning, and, unfortunately, the Senate is scheduled to vote at 10 o'clock. That vote is now underway, but my intention is to make my opening statement, and then recess briefly so we can vote. I apologize to the witnesses, but this is part of what has happened in the Senate when votes are scheduled at the last moment.

I would just start with this chart. We have all said what a difference a year makes. Last year we were all told that we were going to see budget surpluses as far as the eye can see, and now we see budget deficits as far as the eye can see, certainly trust fund deficits that continue throughout the next decade. And there are very large deficits.

Let's go to the next chart. Last year we were told that outside the trust funds we would have some $2.7 trillion of surpluses over the next decade. Now we see, instead of surpluses outside the trust funds, deficits of $2.2 trillion.

That means $2.2 trillion will be coming out of the trust funds of Social Security and Medicare. Many of us think that is unwise given the fact the baby boomers start to retire in just 6 years. But that is the factual circumstance we face.

The areas that we are going to examine today include the construction programs for highways and bridges. We see in the President's budget about a 27 percent cut from last year. Last year we provided roughly $32 billion. This budget will be roughly $23 billion, so about a $9 billion cut—actually, something a little bit less than that. It is a 27 percent reduction, and we will go into some of the reasons for that.

Earlier this month, the OMB Director said that these proposed highway cuts were not a policy decision, but the results of a simple calculation based on the law. The fact is there is nothing in TEA–21 and nothing in the Budget Act that prevents the President or the Congress from providing additional funding for the highway and bridge program beyond the funding levels that are guaranteed in TEA–21.

We can add, the President could have added, so that we would be reducing the level of cut that is before us. I am concerned that the President's proposed highway and bridge-building budgets will force a loss of over 300,000 jobs across the country, just as the economy is starting to rebound.

In addition, the President's budget will significantly reduce Federal funding for highway construction and maintenance at the same time as nearly 40 States are being forced to scale back their State budgets in light of their constitutional requirements to run balanced budgets.

The second area that we will examine is how the President's budget would reduce the Army Corps of Engineers' ability to carry out and complete crucial water and flood control projects across the country. Within the total for the Army Corps, the budget provides $1.4 billion for the primary project construction account, and this is roughly $300 million less, or an 18 percent cut from the 2002 enacted level of $1.7 billion.

Now, what does that mean? For people in the community of Grand Forks, North Dakota, in my home State, it means they will have to wait an additional 2 to 3 years to be safe from floods. That is not a result any of us wants, and we need to work together to see if we can't do better.

I am afraid that my State's story is not unique. Projects from Texas to Missouri to Washington State will also be funded substantially below what is needed to get the job done in a cost-efficient way. Not only are projects being delayed, but in order to stay within the proposed 2003 funding level, the Corps may actually have to terminate ongoing construction contracts at a cost of up to $190 million to taxpayers.

So, again, we have got to find a way to work together here to address these challenges.

In education, which is the third area that we will examine today, the President's education budget promises to leave no child behind. At a time when more is being demanded from our schools, more accountability, more testing, better results, I was particularly disappointed to find that just one month after the President signed into law the landmark education reform bill, No Child Left Behind, his budget actually cuts funding for these programs by $90 million.

Again, I want to thank our witnesses for being here to testify. I will go to my colleague, Senator Bond, for any opening statement that he would like to make.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Well, thank you very much, Mr. Chairman, and welcome to our witnesses today.

Mr. Chairman, I would agree with you on the first part of your macroeconomic analysis. It looked a year ago that we were going to be running surpluses. But, frankly, we have now found that the recession that started back early in the year 2000 has continued. Certainly it took an even greater dip with the tragedies of September 11th. And it is clear that we are going to be running a deficit. But when we are in a recession like this, I think that for the long-term health of our trust funds, the Social Security fund and everything else, we have got to restore economic growth. Economic growth is far more important right now than trying to be Herbert Hoover and run a surplus when we are in a recession.

You and I, Mr. Chairman, started out with the Deficit Reduction Caucus when we first got here in 1987, a lonely little group, and all of a sudden we found that we were getting spending under control. We happened to disagree a little bit on how we got there. You think it was tax increases; I think it was budget cuts. But we got to where we wanted to be.

Now, with an economic downturn, it is time to put our foot back on the accelerator, not the brake. And I share the concerns—I know Senator Domenici is going to talk about highway funding. I was very proud in TEA–21 to be the author with the late Senator John Chafee. We call it the Bond–Chafee proposal in Missouri. I guess elsewhere it is called the Chafee–Bond proposal in the other 49 States and Washington. It said that what we get in ought to be paid out, and we have been for many years suffering from deficits in that trust fund.

Now, because of the wild swings, we potentially suffer significant disruption in highway construction. Frankly, I can think of nothing more important to helping get our economy to grow than to continue with investments in highways and water transportation. And that brings me to Secretary Parker. I was going to say some really nasty things about this budget, and I felt bad about it, until I was told by my staff that Secretary Parker in his previous transmogrification had similar and stronger things to say when totally ineffective and inadequate budgets were proposed for the Corps.

So I am emboldened by that, Mr. Secretary. I was just going to lay out some questions, and you can think about them. I don't think you would be permitted to answer them. But knowing how injurious the budget requested by OMB is to the Corps of Engineers, if Congress actually passed the Administration's budget for the Corps—and I guarantee you it will not—would you recommend the President veto it? You might think about that one.

And let me ask you to consider some things. I think you know, but I don't think the people at OMB know. Am I wrong to say the

President supports economic growth, the President wants to put people back to work, the President supports trade, and the President knows that trade will help restore economic growth and jobs? The President knows that you can't FedEx or e-mail grain to overseas customers. The President knows that there is a relationship between efficient shipping and international competitiveness. The President knows that water transportation is the artery of the Midwest to the world markets. And he supports the competitive shipping options for United States exporters. He knows that water transportation is safe and efficient and environmentally friendly and burns less fuel and creates less congestion and less pollution, and that one medium-sized hull can carry the grain of 900 trucks.

We know that he went down the Mississippi River corridor for a reason in New Orleans, and it wasn't just for Mardi Gras. I think he was interested in seeing how we ship grain to the overseas markets. And I think he understands that you can't support big river navigation without supporting the smaller ports and tributaries that feed traffic to the big rivers. If I am wrong on that, please advise me.

Two years ago, the Corps testified that a sloppy budget sent up by the previous Administration, if enacted, would conservatively result in an estimated $376 million increased cost to the Federal Government and $3.9 billion in foregone benefits. And I might ask you, in terms of cost inflation, delays, and resulting flood damage, if you could tell us how much this budget, with their cuts, will cost us.

As I said, you might think back to some of the comments you made when you were on the House Energy and Water Appropriations Subcommittee. As a matter of fact, I am going to suggest to Chairman Reid, our Energy and Water Appropriations Chairman, that he consider bringing up the OMB staff since they wrote the budget for the Corps, and maybe they could explain it.

For the record, Mr. Chairman, I wonder if we can get the names of the staff people at OMB who write the Corps budget and find out how long they have been in the natural resources section at OMB, because I think we need some budget reform to reduce waste. And I think we can start by saving the Corps the cost and burden of submitting budgets to OMB because it is a waste of time. And we can perhaps eliminate the positions at OMB who work on the Corps budget because, since Congress totally has to rewrite it, the positions are a total waste of the taxpayers' money.

Chairman CONRAD. I think you got the attention of people at OMB this morning, Senator Bond.

Senator BOND. I have written them letters. I have talked to them. I have sent out letters. I don't know what else to do. Maybe I can walk in on stilts. But at least I am going to find out who is doing these dumb things and why and what their explanation for it is. And I am sure that Secretary Parker has been told to say some things, but he is not the one who did it. I know General Flowers didn't do it.

Chairman CONRAD. Again, it can't stand. I mean, it doesn't—it just doesn't make any sense. It doesn't make any economic sense.

Let me just say in response to Senator Bond that we were allies at the time that this country desperately needed deficit reduction, and we were a lonely band. But we did help get the country back on course, and it wasn't just a matter of tax increases. It was spending cuts. And we were advocates of a balanced program because the hole was so deep at that time, we had to do a little bit of everything to get this country back on track, and working together we did.

I also want to make clear I agree with Senator Bond; it would not be wise at a time of economic downturn to cut spending or raise taxes. That would be Hoover economics, and I don't favor that. But we are not talking about a plan that is just a 1-year plan. The President sent up here a 5-year budget plan. He is forecasting strong economic recovery, which we all hope occurs. But he is also forecasting deficits for the next decade, and we are going to have to face up to that. We can't do things that counter the cycle now because of our economic condition. But, looking ahead, we have got to face up to these deficits.

With that, we are going to go and take a 10-minute break, and we will be back to open the hearing and the statements from the witnesses. Again, I apologize. Obviously when this hearing was scheduled for 10 o'clock, there were not votes scheduled, and previously there have been attempts to prevent scheduling votes until committees of Congress have completed their morning hearings. Because of the press of business, apparently that has not been what was done today, but we will return as quickly as possible, and we ask for your indulgence. [Recess.]

Chairman CONRAD. The committee will come back to order. Again, I apologize to the witnesses.

Senator Domenici has now joined us, and we will ask him for his opening statement and then go to the witnesses for their presentations.

Senator Domenici, it is good to have you back.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much. Good to be here, Mr. Chairman.

Let me say to the witnesses, I am sorry I wasn't here earlier. We could have gotten this perhaps behind us. But let me abbreviate my remarks and ask that the entire prepared statement be made a part of the record.

Chairman CONRAD. Absolutely.

Senator DOMENICI. I think it is fair to say, Mr. Chairman that the Olympics are over and March Madness begins at the end of the week. There is no question about it. We are not talking about the NCAA or the Olympics. We are talking about this, the madness that will occur now for the next two and a half months here in the Congress as we attempt to make some sense out of budgeting for our country in the midst of recovering from a recession and in a war, very different than usual times that we have had here in this committee to put budgets together.

I want to break my remarks up into the two parts that are logical. First, with reference to the Highway Trust Fund, the funding there, let me suggest that it is very vivid in my mind, and perhaps in yours, Mr. Chairman, when we had this very big debate on the floor of the Senate. Senator Byrd and Senator Gramm from Texas wanted to change the formula and say that every penny that came in from gasoline tax ought to be spent—that was a very big debate that passed overwhelmingly—that every nickel, every penny, every quarter that comes in you spend that year. That is the law, and the most interesting thing is that when you apply the law that we passed then, the trust fund has less money than we expected because we are driving less and the prices are lower.

So what the President's people did is just come along and apply the formula. The formula was every penny that comes in gets spent. It just happened that the pennies were fewer.

I want to make it clear and, to the extent that this helps you in any way with putting your budget together, this Senator doesn't believe—I believe we ought to go ahead and fully fund on schedule as prescribed, as expected, rather than reducing it by the amount that we did not receive. And the reason is the States—yours, mine, and all the others—and the entities under them that received this money, they all are on a timetable. They have let contracts. This is no way to handle highway funding in the United States. There are a lot of reasons that we ought to be maximizing the funding, but the real reason here is that it is not fair to our States that we would now go back on not only the formula but we would go back on the amount that they actually expected to get because they were prudently anticipating this money under the basic underlying formula. It didn't come in through not fault of their own.

Now, if somebody wants to save some money over the long run, then I think they could look out at the next 5 years and say maybe that next 5 years we will pay back this $4 or $5 billion. But from my standpoint, I believe that this unexpected disturbance of the highway program is not justified, and certainly as we are coming out of this recession, there is even more reason for it to be unjustified.

The Corps of Engineers, I understand that I missed Senator Bond's—I don't know what one would call it, but certainly "critical analysis," perhaps would be the right way to say it, of the Administration's Corps budget. I didn't hear it, so I can't say that I agree with every word of it. But let me suggest we can't live with the Corps of Engineers budget that the Administration put forth. I am hopeful that between Mr. Parker and General Flowers you will be able today to tell us how difficult it will be, what it will cause if we, in fact, follow the President's suggested numbers.

I kind of wonder who helps put this together and whether they are serious or whether they expect us to raise the amount. I can't tell which one yet. But the argument that we have too many projects that are not yet completed, in other words, we have an abundance or an overload of projects, we don't need any new starts, frankly, maybe that overload is getting bigger because we don't have enough money to finish them and we have to start new ones without enough money to stay on schedule.

So I don't know what the right number is, but let me just say I don't think the right number is what the Administration has proposed with reference to the Corps of Engineers water programs and related activities.

Thank you, Mr. Chairman.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Mr. Chairman it is good to be back.

The Olympics are over and March madness begins the end of this week. And I am not talking about the NCAA basketball tournament. I am talking about the significant amount of work needed to draft and agree to a Congressional budget resolution over the next four weeks.

Once again, Mr. Chairman, I extend to you my offer to work in a bipartisan manner to see if we can craft a fiscal blueprint for the Congress.

Today we have two witnesses from the Administration—representing two agencies—whose budgets are important in our drafting a budget resolution.

Let me go straight to the Federal Highway Administration. Welcome Administrator Peters.

Back in 1998 we all worked hard to find a solution to highway funding so that spending for highways was tied directly to the Federal gas tax revenues being deposited in the highway trust fund. Senator Byrd and Senator Gramm on this Committee were instrumental in bringing about this new law called TEA–21.

The President's budget follows precisely that law. Up until this year, the formula in TEA–21 tying gas tax receipts and spending authority provided $9.2 billion more in highway spending authority than was assumed at the time the law passed.

But because of the dramatic lower gas tax receipts associated with the slower economy last year, this adjustment is now a negative $4.4 billion—with states receiving nearly $23.5 billion next year.

I continue to support the linkage between Federal gas tax receipts and Federal spending on highways. But much like the rapid and unexpected swing in the surplus estimates last year, this large unexpected swing in gas tax revenues has disrupted States' long-term transportation construction plans.

TEA–21 worked the way it was supposed to work—gas tax revenues went up and spending authority went up. But the large, unexpected swing in revenues this last year needs to be evened out, and I hope that when this bill is up for authorization next year we can reexamine the formula that caused this dramatic swing, and try to prevent similar occurrences in the future.

In the meantime, I will propose to my members on this side that while keeping the linkage of gas taxes and highway spending in the future, that at least for the FY 2003 budget, I will recommend that we add back $4.4 billion in highway obligations to the President's budget. This will fund the program at the level States anticipated originally in TEA–21. And this will prevent the large unexpected disturbance in State highway programs at this time when States are having to address other important budget decisions.

Finally Secretary Parker, as we understand the President's budget request, the Corp will be reduced about $600 million from last year.

Further, your budget includes no funding for any new construction starts next year, with the exception of one on the Colombia River. No new construction contributes to about half of the savings in your budget.

The Budget Committee of course does not make these line-item decisions. But the Energy and Water Appropriation Subcommittee, on which I serve as the Ranking Member, does. So I will have an opportunity to visit with you again Mr. Secretary.

At a minimum, however, I understand the President's argument that new construction starts have been significant over the last many years, and that this may be contributing to delays in completing those projects.

So to reduce the back-log of these projects already underway, no new construction projects are requested next year. Of course, another way of addressing the back-log of ongoing projects is to provide more funding for them.

Some balance will be needed between these two approaches if we are to try to reduce the backlog. At a minimum I would assume that a freeze on the Corp's budget next year, would allow us to reach some accommodation between the sure demands for new construction projects next year, preventive maintenance on existing projects, and finally reducing the time required to complete current projects.

I look forward to the two witnesses' testimonies. And once again, Mr. Chairman, it is good to be back.

Chairman CONRAD. Thank you, Senator Domenici. And, again, I want to say how good it is to see you back here at the dais, and we missed you very much. And we are glad to see that your health has recovered and you are ready to go as we enter budget season in earnest.

We are going to turn now to the witnesses. Mary Peters, the Administrator of the Federal Highway Administration, who is accompanied by Donna McLean, the Assistant Secretary of Transportation for Budget, welcome to you both. We are glad you are here. We will go first with you, and then we will go right to our second set of witnesses on the first panel: the Honorable Michael Parker, the Assistant Secretary of the Army for Civil Works, who is accompanied by Lieutenant General Robert Flowers, the Chief of Engineers for the Army Corps.

With that, Ms. Peters, why don't you proceed?

STATEMENT OF MARY E. PETERS, ADMINISTRATOR, FEDERAL HIGHWAY ADMINISTRATION, AND DONNA MCLEAN, ASSISTANT SECRETARY OF BUDGET AND PROGRAMS, AND CHIEF FINANCIAL OFFICER, UNITED STATES DEPARTMENT OF TRANSPORTATION

Ms. PETERS. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, thank you for the opportunity to testify today on the effects of the President's fiscal year 2003 budget on the Federal Highway Administration. It is an honor to be here today with Assistant Secretary for Budget and Programs and the Chief Financial Officer of the Department of Transportation, Donna McLean. With your permission, we will submit a joint written statement for the record.

Our highways are the critical links in our Nation's multi-modal surface transportation system. Our challenge is to maintain our high-quality network while increasing safety, improving mobility, and promoting environmentally responsible project decisions, and, of course, efficient program delivery. Our ability to accomplish these objectives is related to the adequacy and the availability of transportation funding.

TEA–21 provided a mechanism for ensuring that revenues into the Highway Trust Fund are spent, and that funding levels for the highway program are aligned with trust fund receipts. Over the past 3 years, the revenue-aligned budget authority (RABA) has provided more than $9 billion of additional highway spending, funding that is now working in our economy.

Due to the recent economic slowdown and current projections of future Highway Trust Fund receipts, a downward adjustment of the highway program occurred when spending was aligned with revenues in the Highway Trust for the 2003 budget year. The calculation is not a policy call. It is a calculation that was based in law and reflected in the budget.

The $24.1 billion funding level for highways, as was proposed in the President's 2003 budget, reflects the spending level enacted in TEA–21, as adjusted for the latest Highway Trust Fund revenue figures. As we approach reauthorization, we need to look for ways to smooth out the current positive and negative swings that result from this adjustment. However, we should not abandon the concept. Linking highway spending to receipts is a fundamental principle of TEA–21. Even with the negative calculation in 2003, over the life of TEA–21 RABA adjustments will provide a net gain of almost $4.7 billion in highway spending.

The 2003 reduction can serve, I think, as a wake-up call for us. Current trends in fuel use as well as technological advances, such as fuel-cell technology, will require us to consider new sources of revenue and leveraged funding if we are going to have sufficient funds for our highway system in the future. Reauthorization gives us the opportunity to consider those important factors.

The Federal Highway Administration budget emphasizes four priority areas: safety, mobility, environmental stewardship and streamlining, and oversight.

Safety remains our first priority and our greatest challenge. Our core construction programs contribute to both safety and mobility by improving roadway design, system condition and capacity, and eliminating hazards. We can also improve the overall operation of the highway system.

Significant progress has been made in the deployment of intelligent transportation systems, but we need to complete that deployment, both in urban and rural areas.

The 2003 budget provides almost $360 million for research and technology funding that will support innovations in safety, system preservation, and congestion mitigation, and including expanded deployment of ITS.

Continued progress in streamlining the delivery of transportation improvements will also improve safety and congestion. We must at the same time, of course, remain respectful stewards of our environment. However, meeting our Nation's mobility goals and environmental stewardship are not mutually exclusive goals.

I am happy to report that the median time it takes to do an environmental impact statement and get to a record of decision has been cut by nearly an entire year. While this is an excellent start, we are committed to accomplishing much more. Our budget proposes $6 million in additional funding for streamlining efforts.

We will also continue to improve Federal oversight and accountability to ensure, as Secretary Mineta has said, the public gets what it pays for. We do owe the public a good return on their investment for public transportation funds, and I call this the public value that we return to them in place of dividends.

We must keep our infrastructure secure and strengthen our commitment to reducing highway injuries and fatalities, even as we obtain additional capacity from the system. Working together, we can provide the American people with a safe, efficient, affordable, and accessible transportation system.

Mr. Chairman and members of the committee, I again thank you for the opportunity to testify today. The Assistant Secretary and I would be pleased to answer any questions you may have.

[The prepared statement of Ms. Peters follows:]

THE PREPARED STATEMENT OF MARY E. PETERS, ADMINISTRATOR, FEDERAL HIGHWAY ADMINISTRATION; DONNNA MCLEAN, ASSISTANT SECRETARY FOR BUDGET AND PROGRAMS AND CHIEF FINANCIAL OFFICER

Mr. Chairman and members of the committee, thank you for the opportunity to testify today on the effects of the President's Fiscal Year (FY) 2003 Budget proposal on the Federal Highway Administration. We are looking forward to working with the Committee and with Congress to achieve the goals outlined in the fiscal year 2003 budget request and to shape reauthorization proposals. Working together, we can meet the transportation challenges flicing our Nation and provide the American people with a transportation system that is safe, efficient, arid accessible, while remaining respectful stewards of the environment.

Overview

As a whole, the strong but flexible multi-modal system developed under the Intenriodal Surface Transportation Efficiency Act of 1991 (ISTEA) and the Transportation Equity Act for the 21st Century (TEA–21) is working well in supporting our Nation's economic growth and improving the quality of life for all our citizens. Our Nation's highways and intermodal connectors are the critical link in the national intermodal transportation system. The challenge is to maintain our high-quality network while achieving our goals to increase safety, ensure national security, improve mobility and enhance productivity, and promote environmentally responsible and efficient project delivery. The 524.1 billion funding level proposed by the President for FHWA in fiscal year 2003 provides funding that is essential to meet this challenge. This funding includes a Federal-aid Highway obligation limitation of 523.2 billion. The fiscal year 2003 request reflects the funding levels enacted in TEA–21, as adjusted to reflect the latest Highway Trust Fund (HTF) revenue figures, and honors the highway category guarantees in that Act.

The key to ensuring that highway-related receipts are spent is that the highway funding level is adjusted each year to reflect the latest information on HTF receipts. At the time of the enactment of TEA–21, highway program funding levels were set based on estimates of HTF receipts. Each year, the level is adjusted using a formula specified in TEA–21. This adjustment ensures that highway spending remains aligned with HTF receipts.

In fiscal years 2000, 2001, and 2002, our Nation reaped the benefits of record]evel funding for surface transportation as authorized in TEA–21. The guaranteed funding level, tied to HTF receipts, has provided the States with much needed resources to support the Nation's highway infrastructure, as Congress intended. In fiscal year 2003, however, declining HTF receipts will, for the first time, trigger a downward adjustment, in the amount of 54.369 billion, in the highway program level, in order to keep highway spending aligned with the status of the HTF. Even with this negative calculation, over the life of TEA–21, these adjustments will provide a net gain of almost $4.7 billion in highway spending.

The calculation of the adjustment is not a policy call—it is a calculation based in law and reflected in the budget, As we discuss the reauthorization of the surface transportation program, we need to look for ways to smooth out current positive and negative swings that result from this adjustment. However, we should not abandon the adjustment concept. Linking highway spending to receipts is a fundamental principle of TEA–21.

Our fiscal year 2003 budget proposes to fund most Federal-aid highway programs from within the obligation limitation, including our major programs: the Surface Transportation Program, the National Highway System, Interstate Maintenance, the Highway Bridge Replacement and Rehabilitation Program, and the Congestion Mitigation and Air Quality Improvement Program. Other TEA–21 programs include the National Corridor Planning and Border Infrastructure Improvement programs and the Transportation and Community and System Preservation Pilot Program. The Emergency Relief program and a portion of the Minimum Guarantee program will continue to be exempt from the limitation. The estimated obligation level for exempt programs in fiscal year 2003 is $893 million.

In the face of declining revenues into the HTF, we continue to strongly support creative financing solutions. Consequently, the 2003 budget includes $99 million to leverage our Federal investment in transportation infrastructure under the Transportation Infrastructure Finance and Innovation Act Program (TIFIA). This investment will translate into over $6 billion in nationally significant surface transportation projects.

As the events of September 11 so graphically demonstrated, a safe and secure surface transportation system is vital to all Americans. We must keep our infrastructure secure and we must strengthen our commitment to reducing highway injuries and fatalities, even as we squeeze additional capacity from the system. To meet this challenge, the fiscal year 2003 Budget for FHWA emphasizes four priority areas: safety, mobility, environmental stewardship and streamlining, and oversight.

Safety

Safety continues to be the Department of Transportation's most important priority. While the number of highway fatalities in recent years has been held relatively flat, despite significantly rising numbers of vehicles on our roads, more than a quarter of a million people have been killed on America's roadways in the past six years, and 41,821 were killed in 2000. There are also more than 3 million police-reported injuries annually. Highway safety improvements are critical to improving these numbers. Success will depend on a balanced approach that addresses driver behavior, vehicle design, and roadway infrastructure and operations challenges. We can, we must, and we will strive to do better.

FHWA works closely with the other Departmental modes, the States, and other partners to improve our ability to analyze roadway safety challenges and to direct investments to specific projects and programs, which will deliver the most value in terms of lives saved and injuries minimized. For example, construction programs continue to contribute to safety by correcting unsafe roadway design and removing roadway hazards. States may—and do—use their Surface Transportation (STP), Interstate Maintenance, and National Highway System (NHS) funds for safety improvements. Safety can be built into every interchange upgrade, intersection redesign, and new facility through safety conscious planning and design. Signing and pavement improvements can enhance the safety of existing and new facilities for all users of the highway system.

Within the STP, 10 percent of funds are reserved under TEA–21 for highway-rail crossing improvements and hazard elimination. The Hazard Elimination program supports efforts to resolve safety problems at hazardous highway locations. Since the enactment of TEA–21, States have obligated $489.3 million in Hazard Elimination funds, and another $707.4 million in optional safety funds have been obligated primarily for Hazard Elimination purposes. These Hazard Elimination expenditures are estimated to have saved 7,200 lives since 1998. The Highway–Rail Grade Crossing Safety program is designed to reduce crashes at public grade crossings, and $499 million in Highway–Rail Grade Crossing funds have been obligated. The grade crossing safety program is estimated to have saved 2,000 lives since 1998.

To meet its highway safety goal, FHWA will focus its safety programs on reducing the most frequent types of fatal crashes through technical assistance, research, training, data analysis, and public information.

From the $359.8 million requested for research and technology programs for fiscal year 2003, significant resources will be invested in improving safety. Part of the research funding will support innovations to improve safety at or near intersections, where 50 percent of all crashes occur, such as brighter traffic signal lights that are more visible to drivers. Research funding also supports speed management techniques, which arc designed to reduce the 30 percent of fatal crashes in which speed is a factor. Rumble strips help prevent run-off-the-road crashes, which account for 38 percent of all fatal crashes. FHWA provides technical assistance to States like Maryland, whose 1999 data show a $182 safety benefit for every dollar spent on rumble strip installation.

National deployment of wireless enhanced 9–1–1 (E–9–1–1) will be accelerated this year. E–9–1–1 is an emergency cellular telephone service that automatically routes calls to the closest public safety answering point and informs the dispatcher of the caller's location. It will save lives. About 25 percent of 9–1–1 calls come from wireless phones. Without automatic location, when callers are unable to describe their location, response times dramatically increase. Response time is a critical factor in determining the survivability of a crash. Also, more timely and accurate information will aid police, fire, and other emergency responders in protecting victims and property and in reducing traffic congestion surrounding the scene.

Recent events have focused attention on the need to ensure the security of our Nation's transportation system and ITS technologies offer many opportunities to significantly improve transportation security. The ITS program is developing and deploying technologies to help States and localities improve traffic flow and safety on streets and highways and address the need for emergency notification and response. This budget proposes to focus the fiscal year 2003 ITS Deployment Program resources of $93 million on ITS technologies that enhance the security of our surface transportation systems.

A major emphasis in ITS will continue to be in the area of intermodal freight. The Department is conducting several ITS operational tests that are designed to improve the efficiency and security of the intermodal movement of freight. The Chicago O'Hare cargo project, which is an operational test, uses a "smart card" and biometric identifiers to identify the shipment, vehicle, and driver during transportation from the shipper to and through the air cargo terminal. Another project, Cargo–Mate, has particular applicability to port and container security, in addition to enhancing efficiency of freight movement. The system is designed to perform real-time processing of asset and cargo transactions, provide for the surveillance of cargo movement to and from ports, and provide an integrated incident and emergency response capability.

To improve safety of motor carriers operating on our highways, as well as national security, a total of $47 million is requested for construction of motor carrier safety inspection facilities on the Southern Border within the Coordinated Border Infrastructure Program. This builds on funding provided in fiscal year 2002 and supports infrastructure improvements necessary to accommodate permanent facilities.

Mobility

Congestion is one of the most obvious results of the mismatch between the growing demands for transportation and the capacity of our systems, particularly in metropolitan areas. Congestion is a complex problem involving many factors. This budget works to address the causes of frustrating delays that face travelers and shippers and impact the Nation's economic efficiency. Funding will support the identification and implementation of a mix of locally preferred investments, including selective additions of new capacity, to improve traffic flow and system reliability. Our progress toward our goal of supporting mobility is tracked by measures such as improvement in pavement and bridge condition and by reduction in the growth of traffic congestion.

States may direct 2003 Federal-aid highway funds, according to their priority needs and goals, to a variety of system improvement and congestion relief purposes. In recent years, approximately 50 percent of Federal funds were obligated for system upgrading purposes, including reconstruction, widening, restoration and rehabilitation, and resurfacing. Consequently, overall highway system conditions, as measured by pavement condition, ride quality, alignment adequacy, and bridge ratings, have steadily improved. In 2000, 90.9 percent of travel on the NHS occurred on pavements rated acceptable or better. In fiscal year 2003, the Department's goal is to increase this to 92.5 percent.

For fiscal year 2002 and beyond, the FHWA has modified its bridge performance measures in order to take into account the actual area and average daily traffic on the bridge. This measure more accurately reflects progress toward meeting our mobility goal. The previous measure of reducing the number of deficient bridges considered all bridges as equal, therefore large bridges with higher average daily traffic were considered the same as smaller bridges with lower average daily traffic. Since the enactment of TEA–21, the condition of NHS and non–NHS bridges has improved significantly. In 1998, the percentage of the Nation s total bridge deck area that was on deficient NHS bridges was 32.6 percent and 32.5 percent on non–NHS bridges. In 2001, the percentage of deck area on deficient NHS bridges was 30.6 percent and 32.3 percent on non–NHS bridges. Our goal for fiscal year 2003 is to improve the condition of bridges so that the percentage of deck area on deficient bridges is reduced to 27.5 percent for the NHS and 29.8 percent for the non-NHS.

The development and deployment of longer lasting materials will mean that facilities will need repair or improvement less often, thereby reducing congestion and safety problems associated with work zones. Research and Technology program funds support multi-year initiatives in pavements, structures, and asset management.

Along with improved condition and strategic expansion of infrastructure, we must address congestion through improved operation of the highway system. Over the last year we developed and tested a system reliability index in 10 cities that we call the "buffer index," the amount of time you have to add to your trip because of system unreliability. It will help cities gauge how well they are doing in responding to incidents, managing their work zones, and responding to weather. The measure will be applied in 22 cities this year.

In the area of congestion mitigation, we have a number of other initiatives underway that will continue in 2003, including three that have great potential for long term impact:

We will be piloting a national campaign to rethink the way we look at work zones. The focus will be on managing the work zone from the perspective of the highway user, emphasizing the concept of getting in, getting out, and staying out.

We are sponsoring a national conference on incident and emergency management that brings together transportation and public safety communities to focus on ways to improve traffic incident response time and traffic incident management methods.

We are working with our State partners to help each make use of the roadway operations self assessment diagnostic tool at least once during the year. The purpose of this tool is to help the operating agencies to identify ways that they can improve the operation and management of their roadway networks.

Other strategies to improve operations include the deployment of ITS to provide more information to drivers faster, enabling them to take the most efficient travel route. Significant progress has been made in ITS deployment since the enactment of TEA–21. We have seen a 37 percent increase in the number of freeway miles with real-time traffic data collection technologies, a 55 percent increase in the coverage of freeways by closed circuit television, a 35 percent increase in the number of buses equipped with automatic vehicle location systems, and an 83 percent increase in traveler information dissemination on our freeways. However, only 22 percent of the freeways in major metropolitan areas are instrumented for real time monitoring. Therefore, ITS deployment must continue to be a high priority for the Department. The search for new technological and innovative solutions to our mobility challenges will be supported by the 2003 budget request for $359.8 million for research and technology.

We are committed, along with our partners at the State and local levels, to maintain, operate, and improve transportation systems to reduce congestion and improve mobility, thus allowing our Nation to compete globally and Americans to enjoy a higher standard of living.

Environmental Stewardship and Streamlining

Implementation of environmentally responsible transportation improvements, delivered on time and within budget, is an important component of the Department's vision for all its programs. TEA–21 gave States and communities additional tools and opportunities to enhance the environment and quality of life for their residents, while directing us to streamline the environmental review process. Within the Federal-aid highway program, NHS and STP funds support programs that also protect the environment. There is also a mandatory 10 percent set-aside from each State's STP apportionment for Transportation Enhancement projects that support historic preservation, bicycle/pedestrian travel, scenic easements, and other enhancements. The CMAQ program supports projects to reduce emissions that often reduce traffic congestion. To minimize the impact of transportation on air quality, FHWA will continue to work with the Environmental Protection Agency and other partners to continue to reduce on-road mobile source emissions.

Continued progress in streamlining the delivery of transportation improvements will also improve safety and ease congestion, but must be balanced against the need to protect communities and the environment. Successful environmental streamlining requires fostering good working relationships across a number of organizational lines. These relationships allow for the development and establishment of reasonable and realistic schedules for advancing major projects. It is important for the Department to facilitate agreement by Federal agencies on time frames for conducting reviews and granting approvals. Working together in partnerships, combining a full range of Federal, State, and local officials and interest groups, will lead to reasonable ways to meet the Nation's transportation needs, while being good stewards of the environment.

The Department's streamlining approach has resulted in:

Reinvention of the environmental review process, through interagency training, development of national programmatic agreements, and guidance that encourages flexible mitigation practices.

Development of a system for dispute resolution that includes draft national procedures, guidance for managing conflict during the project development process, and assistance by qualified dispute resolution specialists to States and project sponsors.

Research conducted to evaluate project time frames, identify reasons for project delays, and assess the effectiveness of implementation efforts.

Assistance, support, and encouragement to develop numerous best practices and pilot projects to catalyze change and lead to even better streamlining outcomes.

Since the enactment of TEA–21 in 1998, progress has been made in streamlining the planning and approval process for projects throughout the country: 34 States have interagency agreements for funding additional persoimel necessary for faster, concurrent reviews; 29 States have adopted a merged process for wetland permits with the Army Corps of Engineers; 26 States have adopted context sensitive design approaches; and 41 States have some level of delegated authority for historic resources. As a result of these actions, between 1999 and 2001, the mean time to process environmental documents for major highway projects has been cut by almost eight months, and the median time has been cut by one year. The Department is well positioned for significant future progress.

We have begun the job, but more can be done. FHWA continues to work with other agencies to advance the Environmental Streamlining National Memorandum of Understanding (MOU). Efforts to cooperatively establish realistic project development time frames among the full range of transportation and environmental agencies will be advanced by this budget. For example, in 2003 we propose to fund $6 million from the FHWA administrative takedown for FHWA support of Federal and State initiatives to identify new, more efficient business processes that will result in more timely project delivery. Working cooperatively to adhere to those time frames is resource intensive, but it is critical to our success. With the additional proposed funding, we will be able to intensify efforts currently underway within DOT that focus on solidifying the interagency partnerships, such as pilot efforts and process reinvention.

Oversight

We must continue to improve Federal oversight and accountability for the expenditure of public funds. Increased emphasis on FHWA's oversight responsibilities must accompany the significant increases that have occurred in the Federal-aid Highway program in recent years if our Nation is to make the "best buys" in safety and congestion relief. FHWA oversight policies were updated and clarified in fiscal year 2001 and their implementation will continue into the requested budget year. Even as legislation has directed FHWA to delegate many project-level authorities to the States, the responsibility for program oversight to ensure the effective delivery of all programs remains with FHWA. Additional resources deployed in this area will enable FHWA to work with the States to improve its management of the Federal-aid highway program, including cost containment, while allowing States maximum delegated authority and flexibility, as appropriate. FHWA will continue to advance asset management and system preservation initiatives to foster more systematic and strategic thinking and investment choices by the State and local governments. Timely investments in the size and makeup of the Federal workforce itself are also crucial with the aging of both the Interstate Highway System and the workforces of our partner agencies in States and localities. We are focusing new attention on workforce development issues and will keep the subcommittee advised of our efforts. As larger and more complex projects are contemplated, a balance must be achieved between addressing the needs of major projects and the vast majority of the program vested in smaller projects.

In 1998–1999, FHWA undertook a major restructuring in order to move program decision authorities closer to our primary customers, the States, and to focus high-level technical expertise in our Resource Centers. Through this redeployment of existing resources we have also been able to fulfill FHWA's commitment to add an additional position in respective Division Offices for the oversight of each major project.

The fiscal year 2003 budget requests a funding level of $318 million for the necessary salaries and benefits for our employees and for ongoing administrative expenses in support of our Federal-aid program. The budget request reflects modest adjustments for mandatory salary and benefit increases and other adjustments for current service levels.

Status of the Highway Trust Fund

The cash balance in the HTF at the end of fiscal year 2001 was 527.740 billion, of which $20.372 billion was located in the Highway Account and $7.369 billion in the Mass Transit Account. Based on the latest projections of income to the HTF reported by the Department of the Treasury, the Department of Transportation estimates that the Highway Account of the HTF has sufficient revenues to support the levels of funding proposed in the President's budget.

Balances in the Highway Account of the HTF should riot be considered as surplus funds. Current commitments of HTF revenues for prior year obligations, as well as unobligated balances of prior year apportionments, exceed $67 billion. However, as reimbursing cash is made available from the HTF, revenues from excise taxes are coming into the HTF. Any consideration of HTF balances must take into account not only current levels of revenue, but also commitments made against that revenue, and projected levels of future income.

Conclusion

The funding requested in 2003 will help improve transportation safety; enhance national security; maintain and expand our transportation infrastructure, as well as increase its capacity; reduce environmental degradation; and improve the quality of life for all our citizens. On behalf of FHWA, we look forward to working with Congress to enact the President's fiscal year 2003 budget in order to provide a viable transportation system to support a strong America.

Once again, thank you for this opportunity to testify today. We will be pleased to address any questions that you may have.

Chairman CONRAD. Very well. We are glad you are here. We appreciate your testimony.

We will now go to Assistant Secretary Parker for his testimony and then open it up for questions.

Senator DOMENICI. Mr. Chairman?

Chairman CONRAD. Yes, Senator Domenici?

Senator DOMENICI. Could I have just 30 seconds?

Chairman CONRAD. Absolutely.

Senator DOMENICI. I failed to mention in my opening remarks the Corps of Engineers' activities in our State when we had the big fire at Los Alamos. I would tell you that anybody that still harbors the ideas of 15 years ago that the Corps doesn't do their job well, they should have been there and watched that. That was a tremendously difficult public works project and program, and I want to, General, thank you for all the things that were done. They are all working. The remnants of that fire are not—there is nothing that has to do with the water flow and the like. It has all been properly handled, and the Mexicans appreciate it.

Thank you, Mr. Chairman.

Chairman CONRAD. Well, thank you for that. I would echo that. You know, in 1997, we had the worst floods in 500 years in North Dakota. I might tell you the Corps of Engineers did an absolutely superb job, and they won that flood fight up and down the valley. We lost it in one place with the circumstance which nobody could have foreseen what we were up against. In fact, Colonel Kasprisin, who led that fight, was in my office yesterday. He is now a top executive with FEMA and one of the most outstanding people I know, just the kind of person you would want handling any disaster. He helped lead the effort at the Olympic Games to provide security out there. He was the FEMA lead person on that. I just have a very high regard for him.

With that, Mr. Parker, please proceed.

STATEMENT OF MICHAEL PARKER, ASSISTANT SECRETARY OF THE ARMY, CIVIL WORKS, DEPARTMENT OF ARMY, ACCOMPANIED BY LIEUTENATE GENERAL ROBERT B. FLOWERS, CHIEF OF ENGINEERS, UNITED STATES ARMY CORPS OF ENGINEERS

Mr. PARKER. Thank you, Mr. Chairman and members of the committee. I first want to thank you for the opportunity to testify today on the President's fiscal year 2003 budget for the Army Corps. I am accompanied, as you said, by Lieutenant General Robert Flowers, who happens to be the 50th Chief of Engineers of the Corps.

I want to summarize my statement due to time constraints, but with your permission, I would ask that my complete statement be entered into the record.

The President's overall priorities are national defense, protecting the American people from terrorism, and reviving the economy. Funds for the civil works portion of the budget in the Corps are very tight. The President's budget for civil works seeks appropriations of $4.3 billion. After adjusting for changes in financing methods, such as retiree costs, this represents an increase of about 7 percent from last year's President's budget and a decrease of about 7 percent from last year's appropriations.

The Bonneville Power Administration, non–Federal cost-sharing partners, and other sources would provide another $0.5 billion, bringing the total civil works program to $4.8 billion. The budget provides construction funding for the principal civil works missions of commercial navigation, flood damage reduction, and environmental restoration. The budget allocates this funding for ongoing construction projects that are known to be consistent with policy, especially 30 projects that are nearing completion, three priority projects, and two projects to meet environmental requirements in the Missouri and Columbia basins.

Also, there is one new start that is required to comply with the Endangered Species Act. There would be no construction funding for non-traditional missions, such as environmental infrastructure. Construction funds are thinly stretch, and there are many construction projects awaiting funds. To reduce the number of projects in the construction pipeline, the budget cuts back the study and design program from recent funding levels.

In the fiscal year 2003 budget, hurricane protection projects are treated comparably with other flood damage reduction projects. For the Mississippi River and tributaries project, the budget emphasizes the flood damage reduction projects on the main stem of the Mississippi River and the Atchafalaya River Basin.

The budget proposes that the Federal Power Marketing Administrations directly fund hydropower operation and maintenance costs at Corps projects. This more reliable funding would lead to more reliable performance at Corps hydropower facilities.

The Corps received $139 million in fiscal year 2001's supplemental appropriations for anti-terror facility protection. We will use those funds for recurring costs, facility assessments and improvements. The fiscal year 2003 budget provides another $65 million for recurring infrastructure protection costs. The budget limits funding for shallow draft harbors and for inland waterways that have low commercial tonnage. The intent is to direct funding from purely recreational harbors and from waterway segments that have high costs per commercial ton mile.

The budget would step up funding for the regulatory program to improve permit turnaround times and improve environmental protection. The Chief of Engineers and I are working to strengthen civil works projects, project planning and review. The chief is focusing on improving planning capabilities and management processes. I am staffing a project planning and review group that will function as part of the Corps' overall vertical planning team. These changes are intended to ensure that technical and policy questions are addressed early in the planning process rather than at the end.

Mr. Chairman, we are all proud of the way the Army Corps of Engineers stepped forward on and after September the 11th, demonstrating its emergency response and recovery capabilities and the importance of maintaining the civil works capability within the Army. The Army Civil Works Program is a wise investment in the Nation's economy and way of life, and it is a great pleasure for me to be able to advocate its funding.

Let me just address some of the things that have been stated this morning.

When I was on the Energy and Water Subcommittee of Appropriations in the House, I always looked at OMB and never had those warm, fuzzy feelings toward them. I have found that after being in the Administration and dealing with them, I still don't have those warm, fuzzy feelings. [Laughter.]

Mr. PARKER. The fact of the matter is that OMB, in giving them credit, they do have a problem. They have a situation that they were forced into. Instead of being able to have surpluses and dealing in an environment where we were determining priorities on spending with surpluses, because of the 9/11 attack we are now caught in a situation where we have these deficits, we have national security as our main goal, and homeland security. I think it would be safe to say that I know the President understands this, and I am hoping that everybody at OMB understands, that this process, we are at the beginning of it, knowing full well that Congress plays a vital role in making the decisions that have to be made to continue the vital work of the Corps.

If the Corps is limited in what it does for the American people, we will see a negative impact on the people of this country. Anyone knows that over the next 20 years, we have to double trade in order to maintain our standard of living. That trade goes over our waterways. And if we don't have the infrastructure in place to make that happen, we will not be able to maintain that.

There have been situations in the past where I have felt sometimes, when I was a member, that OMB sometimes gave low numbers, knowing full well that Congress would plus those numbers up. I wouldn't be so brash as to say this was the case here, that we have to ask OMB as far as what their opinions are.

The fact of the matter is, as Assistant Secretary of the Army for Civil Works, I look forward to working with this Committee, being able to put together a package. In the final analysis that package will go to the President for signature, where we can fulfill our responsibility to the American people within the work of the Corps itself.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Parker follows:]

The Prepared Statement of the Honorable Mike Parker, Assistant Secretary of the Army (Civil Works)

Mr. Chairman and distinguished members of the Committee:

Introduction

Thank you for the opportunity to testify before this Senate Budget Committee and to present the President's budget for the Civil Works program of the Army Corps of Engineers for Fiscal Year (FY) 2003.

Accompanying me this morning is Lieutenant General Robert B. Flowers, Chief of Engineers.

Army Civil Works Program for Fiscal Year 2003

The President's fiscal year 2003 budget confronts a two-front war against terrorism while taking steps to restore economic growth. In order to finance the war against terrorism it moderates spending in the rest of government. This year's budget also takes the significant step of assessing performance in government, and begins to tie what works and doesn't work to spending decisions. This will help ensure that government programs that fail to achieve their purpose can be held accountable and, perhaps, be reformed or ended as a consequence.

The fiscal year 2003 budget for Army Civil Works provides funding to continue the development and restoration of the Nation's water and related resources, the operation and maintenance of existing navigation, flood damage reduction, and multiple-purpose projects, the protection of the Nation's regulated waters and wetlands, and the cleanup of sites contaminated as a result of the Nation's early efforts to develop atomic weapons. The budget includes new appropriations of $4.29 billion. The new appropriations are expected to result in fiscal year 2003 outlays of approximately $4.47 billion.

Three legislative initiatives support the fiscal year 2003 Army Civil Works budget. First, the Administration is proposing government-wide legislation under which the full costs for Federal retirees will be allocated to agency programs instead of the Office of Personnel Management. Under this proposal, $115 million of the $4.29 billion represents retiree costs not previously borne by the Army Civil Works program.

Second, the Administration is proposing legislation under which three Federal power marketing administrations will finance hydropower operation and maintenance costs directly, in a manner similar to the mechanism currently used by the Bonneville Power Administration in the Pacific Northwest. This proposal is described below in greater detail.

Third, the Administration is proposing legislation to increase fees at Corps of Engineers lakes and recreation areas and to extend the existing recreation fee demonstration program. This proposal also is described below in greater detail.

The new appropriations, including new funding for retiree costs, will derive an estimated $3.258 billion from the general fund, $764 million from the Harbor Maintenance Trust Fund, $85 million from the Inland Waterways Trust Fund, $34 million from Special Recreation User Fees, and $149 million from three Federal power marketing administrations for hydropower operation and maintenance costs.

Other program funding is estimated at $464 million. This total includes $118 million transferred from the Bonneville Power Administration for operation and maintenance of hydropower facilities in the Pacific Northwest and $272 million contributed by non-Federal interests.

The budget represents an increase from the fiscal year 2002 budget of 7 percent and a decrease from fiscal year 2002 appropriations of 7 percent, including adjustments for the new retiree costs and excluding emergency supplemental appropriations and inflation adjustments.

PROGRAM HIGHLIGHTS

Priority Missions

The budget gives priority to ongoing studies, projects and programs that provide substantial benefits under the principal missions of the Civil Works program, which are commercial navigation, flood damage reduction (including coastal storm and hurricane damage reduction), and environmental restoration. No funds are provided for studies and projects that carry out non-traditional missions that in the view of the Administration should remain the responsibility of non-Federal interests or other Federal agencies, such as wastewater treatment, and municipal and industrial water supply treatment and distribution. In addition, the budget does not fund individual studies and projects that are inconsistent with established policies governing the applicable missions.

Emphasis on Ongoing, Budgeted Construction Projects

The Corps estimates that the balance of funding needed to complete all active construction projects and authorized and unauthorized projects in pre-construction engineering and design is about $44 billion. Of this, about $21 billion is necessary to complete the flood control, navigation and environmental restoration projects funded in the budget in the Corps Construction, General program. This represents 12 years of funding at the level enacted in fiscal year 2002 just to finish funding ongoing Construction, General projects supported in the budget.

More projects have been started than can be prosecuted efficiently, given the limitations on available funding. The budget directs funding to ongoing projects that have been determined to be consistent with policy, in order to quickly realize the benefits that those projects are designed to provide.

Shore Protection

The budget treats projects to protect coastal structures from hurricane and storm damage on a par with other types of flood damage reduction projects. The Administration continues to be concerned about the appropriate level of non-Federal cost sharing for shore protection projects, and is considering proposing legislation to adjust Federal and non-Federal cost shares.

Direct Financing of Hydropower Operation and Maintenance Costs

Historically, each year the Army Civil Works program has financed the operation and maintenance costs of Corps of Engineers hydroelectric facilities, and in the next year Federal power marketing agencies have repaid the Treasury for these costs from the revenues provided by ratepayers. The exception has been in the Pacific Northwest, where under section 2406 of the National Energy Policy Act of 1992, Public Law 102–486, the Bonneville Power Administration has directly financed the costs of operating and maintaining the Corps hydroelectric facilities from which it receives power.

In 1999, the General Accounting Office found that the Corps hydropower facilities are twice as likely to experience "unplanned outages" as private sector facilities, because the Corps does not always have funds for maintenance and repairs when needed. Corps facilities experience unplanned outages approximately 3.7 percent of the time, compared to the industry average of 2.3 percent.

To address this problem, the budget proposes that the Southeastern Power Administration, the Southwestern Power Administration, and the Western Area Power Administration finance hydropower directly, in a manner similar to the mechanism used by Bonneville. The budget contemplates that these power marketing administrations will make those hydropower operation and maintenance investments that they believe are justified in order to provide economical, reliable hydropower to their customers and that, as a consequence, unplanned outages will decline over time to levels comparable to the industry average.

Protection of Critical Facilities

The Administration sought $139 million in emergency supplemental appropriations to the Operation and Maintenance, General account for the protection of critical Civil Works facilities from terrorist attack. Congress provided these funds in Division B of the fiscal year 2002 Department of Defense appropriations act. The funds will be used to pay recurring facility protection costs and one-time costs to assess the vulnerability of each facility and to initiate "hard" protection of critical facilities. The Corps expects to complete its facility assessments by the end of April 2002.

The Administration is continuing its commitment to facility protection in fiscal year 2003. The budget includes $65 million for recurring security costs ($64 million in Operation and Maintenance, General and $1 million in Flood Control, Mississippi River and Tributaries), not including new retiree costs). The Administration will evaluate the need for additional security measures based on the conclusions of the facility assessments.

Fee Increases at Recreation Areas and Lakes

The Army is undertaking efforts to increase day use fees, camping fees, annual pass fees, and special use permit fees under existing authority. These efforts are expected to help increase annual recreation user fee receipts to $38 million in fiscal year 2002 from less than $34 million in fiscal year 2001. In addition, under proposed legislation, recreation user fees and shoreline permit fees increases would be phased in through fiscal year 2006. The legislation also will extend the existing demonstration program under which recreation user fee receipts over $34 million per year are automatically available to the Corps to spend on operation, maintenance, and improvement of its recreation facilities. We project that annual recreation and shoreline permit fee receipts will grow by $6 million in fiscal year 2003 to $44 million, and an additional $5 million per year in fiscal year 2004 through fiscal year 2006, to a total of $59 million in 2006.

Discussion of Appropriation Accounts

General Investigations

The budget for the Civil Works study program is $108 million, including $5 million for new retiree costs. This is a significant reduction from funding levels in the budgets and appropriations for previous years. The reduced funding level for General Investigations is intended to slow the rate at which studies and pre-construction engineering and design efforts are carried out and completed and the rate at which projects with completed studies are added to the existing construction backlog. Cost-sharing sponsors, who are being asked to invest in studies and design, expect timely construction once studies and design are completed and the projects are authorized. This reduced funding level reflects the Administration's priority of completing policy-consistent projects that are under construction before initiating new work.

No new study starts are included in the budget. However, to the extent allowed within available funding, policy-consistent studies that are under way will continue to move seamlessly from the reconnaissance phase to the feasibility phase and from the feasibility phase to pre-construction engineering and design as they receive the necessary levels of review and approval within the Corps and the Army. Coordination, technical assistance, and research activities also will be continued, including continued Army participation in the National Estuaries Council.

Construction, General

The fiscal year 2003 budget for the Civil Works Construction, General program is $1.44 billion, including $22 million for new retiree costs. Of that total, $85 million will be derived from the Inland Waterways Trust Fund to fund the construction and major rehabilitation of inland waterway projects and $15 million will be derived from the Harbor Maintenance Trust Fund to fund the Federal share of construction costs for dredged material disposal facilities at operating harbor projects.

Funding is included in this account for continuing projects for which the Administration has completed its review and made a determination that the project supports priority missions and is consistent with established policies. No funds are included to initiate construction of discretionary new projects. Furthermore, no funds are included to continue planning, engineering, design, or construction of projects added by Congress in fiscal year 2002 for which the Administration has not completed its review and established a favorable position.

The budget for the Construction, General account gives priority to projects that can be completed in fiscal year 2003. Thirty projects, or 15 percent of the 194 budgeted projects, will be completed. The budget also includes substantial CG funding, net of new retiree costs, for three priority projects: $120 million for the New York and New Jersey Harbor deepening project; $77 million for the Olmsted Locks and Dam project in Illinois and Kentucky; and $148.5 million for restoration of the Florida Everglades, including $37 million for the Comprehensive Everglades Restoration Plan.

The budget also ensures that environmental requirements for the Columbia River Basin and for the acquisition and development of shallow water habitat on the Missouri River will be met. For the Missouri River, $17.5 million is allocated to the Missouri River Fish and Wildlife Mitigation Project to expedite restoration of aquatic habitat. For the Columbia River Basin, the budget includes $98 million for the Columbia River Fish Mitigation project and $2 million for a new construction start, the estuary habitat restoration program for the lower Columbia River, which must be started to meet legal requirements. (These figures do not include new retiree costs.) Both the ongoing project and the new project on the Columbia River are required in fiscal year 2003 to comply with Biological Opinions issued under the Endangered Species Act by the National Marine Fisheries Service and the United States Fish and Wildlife Service for the recovery of threatened and endangered fish species.

The budget provides, net of new retiree costs, $78 million for continuing planning, design, and construction of projects under the Continuing Authorities Program. These are small projects for flood damage reduction, navigation, shoreline protection, streambank protection, navigation project impact mitigation, clearing and snagging, aquatic ecosystem restoration, beneficial uses of dredged material, and project modifications for improvement of the environment. The budget includes no funding to initiate new construction under the Continuing Authorities Program.

The Administration is proposing legislation to require agencies to pay the full cost of the Federal Employees Compensation Act (FECA). The Department of Labor will add a small surcharge to the amount charged to each agency for FECA benefits to ensure full coverage. The CG account includes an additional $1 million in the Workmen's Compensation line item to cover the surcharge.

Flood Control, Mississippi River and Tributaries

The budget includes $288 million for the Mississippi River and Tributaries program, including $7 million for new retiree costs. The budget directs funding to the priority flood damage reduction projects on the mainstem of the Mississippi River and in the Atchafalaya River Basin, Louisiana, including the completion of the Louisiana State Penitentiary Levee, Louisiana, project. No funding is provided for studies or projects that represent non-traditional missions or are inconsistent with established policies. No funding is provided for new studies or projects. $1 million is included for the recurring costs of protecting critical Mississippi River and Tributaries facilities from attack.

Operation and Maintenance, General

The budget provides funding for the Army Corps of Engineers to carry out its operation and maintenance responsibilities at Corps-operated projects for the purposes of commercial navigation, flood damage reduction, recreation, natural resources management, and multiple purposes including hydroelectric power generation.

The overall budget for the Operation and Maintenance, General, account is $1.979 billion, including $65 million for new retiree costs. Of this amount, $749 million will be derived from the Harbor Maintenance Trust Fund, $34 million will be derived from Special Recreation User Fees, and, under proposed legislation described above,

$149 million will be derived from the direct funding of hydropower operation and maintenance costs by three Federal power marketing administrations.

In addition to these funds, operation and maintenance of hydropower facilities in the Pacific Northwest will be directly financed by a transfer of approximately $118 million from Bonneville Power Administration revenues.

The budget directs funding for navigation projects to those that support commercial or subsistence usage. The budget provides: $536 million for deep draft harbors (harbors with authorized depths of greater than 14 feet); $47 million for shallow draft harbors, with priority given to those harbors that serve commercial activities or provide a means of subsistence; $384 million for inland waterways with commercial traffic of more than one billion ton-miles per year; and $57 million for waterways with less commercial traffic, with priority given to those operation and maintenance activities that provide the highest return, generally on the waterways and waterway segments with the lowest average cost per ton-mile (these figures do not include new retiree costs).

The budget includes $64 million, not including new retiree costs, for the recurring costs of protecting critical Civil Works facilities from attack.

Regulatory Program

The budget for the Regulatory Program is $151 million, including $7 million for new retiree costs. These funds will be used for permit evaluation, enforcement, oversight of mitigation efforts, administrative appeals, watershed studies, special area management plans, and environmental impact statements, in order to provide effective regulation of the Nation's waters and wetlands and expedite permit decisions.

The $151 million represents a much-needed increase for the Regulatory Program and supports responsive service to the public. This funding will enable a reduction in average permit processing times from an estimated 160 days in fiscal year 2002 to an estimated 120 days by the end of fiscal year 2004. The budget also provides additional resources for monitoring of compliance with issued permits and for partnerships with States and local communities through watershed planning efforts.

Formerly Utilized Sites Remedial Action Program (FUSRAP)

The Formerly Utilized Sites Remedial Action Program (FUSRAP) is an environmental cleanup program for sites contaminated as a result of the Nation's early efforts to develop atomic weapons. Congress transferred the program from the Department of Energy in fiscal year 1998. We are continuing to implement needed cleanups at contaminated sites. This year's budget is for $141 million, including $1 million for new retiree costs.

Flood Control and Coastal Emergencies

This program finances preparedness, response, and recovery activities for flood, storm, and hurricane events, and preparedness activities in support of the Federal Emergency Management Agency through the Federal Response Plan. The budget proposes $22 million for this program, including $2 million for new retiree costs. This amount will be used, together with any funding that may remain available from prior year appropriations, to finance programmed and emergency activities during fiscal year 2003.

General Expenses

Funding budgeted for the General Expenses program is $161 million, including $6 million for new retiree costs. These funds will be used for executive direction and management activities of the Corps of Engineers headquarters, the Corps division offices, and related support organizations.

GOVERNMENT PERFORMANCE AND RESULTS ACT

A performance plan is in preparation for the Army Civil Works program, based on the fiscal year 2003 budget. After completion of Administration review, the plan will be submitted to the Congress.

ARMY CIVIL WORKS PLANNING AND REVIEW PROCESS

Both the Army Corps of Engineers Headquarters and the Office of the Assistant Secretary of the Army for Civil Works are taking steps to strengthen the project planning and review process. We have undertaken these efforts to ensure that the Corps provides this Nation with technically sound, environmentally acceptable, and justified projects.

Improved Planning Capabilities. The Corps is improving the competency of its planning cadre through the development of a long-term training and development plan. The Corps is developing a web-based information system to enable planners to find the information they need to do their jobs more efficiently and effectively.

Process Improvements. To ensure more accountability, the planning organization within each district will manage the planning process from problem identification to the development of a proposed project. The Corps has clarified technical and policy review responsibilities. The Corps Headquarters has consolidated the policy and planning functions and initiated a new business process under which one individual at Corps Headquarters is responsible for solving study and project issues.

Environmental Advisory Board. The Chief of Engineers has reactivated the Environmental Advisory Board (EAB) and redefined its role to include advising him on policy and specific projects. This participation by the EAB can contribute to improved project formulation and thereby reduce the need for mitigation and the potential for conflict or litigation.

Independent Peer Review. The Chief of Engineers has endorsed, in concept, the establishment of an independent panel of experts to review Corps projects. The proposal is to establish a panel of six members, to include three members from outside the Corps, who would review large, complex, or controversial projects. Additionally, in response to Section 216 of the Water Resources Development Act of 2000, the Corps contracted with the National Academy of Sciences (NAS) to study and make recommendations on the independent peer review of Corps projects. The Administration will formulate its position on this issue in the coming months.

Plan Formulation and Evaluation. The NAS also will evaluate the various techniques, models, and processes used to formulate Corps projects and will consider modernizing the Federal Principles and Guidelines. Consideration will also be given to how the Corps conducts multi-purpose formulation and evaluation and trade-off analysis, and how it integrates environmental, economic and social considerations. Finally, the NAS will review various approaches to ecosystem restoration and application of adaptive management to the planning and operation of projects. These reports will be completed in the summer of 2003.

Army Civil Works Planning and Project Review. Recently, I formed a new, four-person group within my office to perform oversight of the Corps planning program and to advise the Corps and me on the application of laws, regulations, and Army policies to project proposals. In particular, this new group will conduct reviews of Corps projects and will help me develop my recommendations to the Administration and Congress on the authorization or modification of projects. To facilitate coordination with the Corps, this group will be co-located with the Corps of Engineers Headquarters. My planning group will engage with the Corps on planning issues as they arise, rather than after reports are completed. My new Deputy for Project Planning and Review and administrative staff already are on board, two positions have been advertised, and the last position will be advertised shortly.

CONCLUSION

I believe that the President's fiscal year 2003 budget for the Army Civil Works program is a solid one. The budget continues support to ongoing work, emphasizes primary missions, and applies resources to areas likely to have the greatest national economic benefit. Providing the requested funds for the Army Civil Works program is a wise investment in the Nation's future.

Thank you.

[The prepared statement of General Flowers follows:]

THE PREPARED STATEMENT OF LIEUTENANT GENERAL ROBERT B. FLOWERS, CHIEF OF ENGINEERS

Mr. Chairman, and Members of the Committee:

INTRODUCTION

I am honored to be testifying to your Committee today, along with the Assistant Secretary of the Army (Civil Works), the Honorable Mike Parker, on the President's Fiscal Year 2003 (fiscal year 2003) Budget for the United States Army Corps of Engineers Civil Works Program.

I am especially honored to have the opportunity to lead the Corps through its current challenges to serve this great Nation in meeting its many water and related land resources management needs.

Thanks to this subcommittee's support, the Civil Works Program remains strong, balanced, responsive, and highly productive. I look forward to working with you in furtherance of our partnership in prosecuting this fine program, so broadly beneficial to our Nation.

In this statement, I will focus on significant challenges for the Nation in light of the September 11th terrorist attacks, and will say just a few words about the Corps role in assessment of national water and related land resources management needs. Accordingly, my statement covers just these three topics:

- Summary of Corps of Engineers actions after the terrorist attacks, especially support to the Federal Emergency Management Agency;
- Highlights of the Civil Works program budget;
- Summary of how the Civil Works Program provides support to the Nation's economic security.

SUMMARY OF CORPS POST-ATTACK ACTIONS

Mr. Chairman, and Members of the Subcommittee, last September 11th the Nation and the world watched in horror and disbelief as the World Trade Center and the Pentagon were attacked by terrorists and the passengers and crews of four air liners lost their lives.

I am proud to say that the Corps of Engineers provided critical support to the Federal Emergency Management Agency in the aftermath of those terrorist attacks. Corps members provided technical assistance for debris removal, electrical power assessment and structural assessments during operations in New York City. Corps members also provided technical assistance for debris removal at the Pentagon. Today, the Corps continues to support FEMA, the Department of Defense, and the Nation in the disaster recovery mission in New York City and at the Pentagon through its execution of the Public Works and Engineering mission. These emergency response and recovery actions take place under Emergency Support Function number 3 in the National Emergency Response Plan, for which FEMA has assigned the lead to the Corps of Engineers.

I would like to highlight some of the accomplishments the Corps achieved in our support:

In the aftermath of the collapse of the World Trade Center towers, it was virtually impossible to exit Manhattan by car or other ground transportation. A virtual armada of boats came together, in an impromptu fashion, crossing the water to reach Manhattan to ferry trapped people out of the area of devastation.

Among those boats were seven vessels owned by the United States Army Corps of Engineers. These craft carried approximately 2,000 stranded citizens from south Manhattan to Brooklyn, Jersey City, and Staten Island. On the return trip, the crews ferried firefighters and relief workers into Manhattan, provided fuel, antifreeze, and oil for the New York City fire trucks, and transported 1,000 gallons of potable water to the firefighters. Personnel on board the vessels also included structural analysts deployed to New York City to assist in the urban search and rescue mission. The collapse of the World Trade Center's twin towers caused so much destruction and devastation to the buildings surrounding them that those buildings were unsafe to enter to conduct a safe search and rescue effort. The Corps deployed surveyors to assist the city's engineers in evaluating some of the more complicated building situations.

An assessment team from the 249th Engineer Battalion (Prime Power) was deployed to the financial district of New York City shortly after the attack. The soldiers provided technical assistance to Con Edison, the power company that provides electric service to New York City and most of Westchester County, in the installation of 56 city-supplied 1500-kilowatt generators to support emergency electrical power requirements. As a result of their efforts, the New York Stock Exchange was up, running, and fully operational on Monday September 1 7th, only four business days after the attack.

On September 13, New York City requested a permit to dredge 120,000 cubic yards of material from around Pier 25 to allow large boats to support rescue and recovery operations. Brigadier General Stephen Rhoades, North Atlantic Division commander, gave permission in record time to dredge and place material in the Newark Bay Confined Disposal Facility. The Corps also dredged Pier 6 in Manhattan, which permitted greater access for barge transportation of debris from the pier to the facility. Prior to this dredging, it was necessary to truck the debris uptown through Manhattan, to a pier that could accommodate the large barges, and then transport the debris to the facility.

At one point, more than 160 Corps of Engineers personnel had deployed from across the Nation to New York City to join the 750 North Atlantic Division employees who work in the city. Those deployed included structural engineers skilled in urban search and rescue, debris management specialists, logistics and contracting personnel, and the soldiers of the 249th Engineer Battalion (Prime Power).

Since the attack, the Corps of Engineers has continued to support and work closely with the Federal Emergency Management Agency in the recovery operations, and we will continue to do so until the operation is complete.

We also are working closely with the Office of Homeland Security in protecting the Civil Works infrastructure from terrorist attacks. We have developed a Civil Works Infrastructure Assessment Program, which to date has consisted of training 250 Corps Engineers and Security personnel; conducting infrastructure assessments of critical projects in each Division; and offering a specialized security training course to Corps personnel through our training facility in Huntsville, Alabama. The Civil Works program received $139 million in emergency supplemental appropriations to fund recurring protection costs at critical facilities and some physical security measures identified in the critical facility assessments.

The immediate response of the United States Army Corps of Engineers is yet another reason I am so proud to be the 50th Chief of Engineers. Corps employees from every division and district called to volunteer to do whatever is needed to support the Emergency response and recovery.

I would like to conclude my comments on the Corps support after these tragic events by quoting the Honorable Thomas White, Secretary of the Army, in a speech he gave shortly after visiting ground zero in New York City. He said, "To the Corps of Engineers I would say. * * * while your history is impressive, given the current situation, your finest hour is a chapter yet to be written. The Nation will look to your extraordinary capability to protect and sustain our infrastructure against a wide variety of threats." Mr. Chairman, and Members of the Committee, the United States Army Corps of Engineers is ready, able, and proud to serve the Nation in its time of need.

The Fiscal Year 2003 United States Army Corps of Engineers budget provides the following:

HIGHLIGHTS OF THE CIVIL WORKS PROGRAM BUDGET

General Investigations	108,000,000
Construction, General	1,440,000,000
Operation and Maintenance, General	1,979,000,000
Regulatory Program	151,000,000
Flood Control, Mississippi River & Tributaries	288,000,000
General Expenses	161,000,000
Flood Control and Coastal Emergencies	22,000,000
FUSRAP	141,000,000
Total	**$4,290,000,000**

CONSTRUCTION, GENERAL BACKLOG

The Corps estimates that there is a construction backlog of about $44 billion, including about $21 billion to complete ongoing flood damage reduction, navigation, and environmental restoration projects consistent with Administration policy, about $8 billion to complete other ongoing construction projects, about $6 billion to complete already started Mississippi River and Tributaries construction projects, and about $8 billion for authorized and unauthorized projects in Pre-construction Engineering and Design.

Available funding is directed toward construction of the ongoing projects that are consistent with Administration policy. One new project construction start is proposed for funding to meet the legal requirements of a Biological Opinion under the Endangered Species Act. No discretionary new project construction starts are budgeted and no new study starts are budgeted.

OPERATION AND MAINTENANCE, GENERAL BACKLOG

The fiscal year 2003 budget of $1.979 billion is $40 million more than the amount enacted in fiscal year 2002, excluding emergency supplemental appropriations and including imputed employee pension and annuitant health benefit costs. We can sustain customer services in fiscal year 2003 with this level of funding. While we join the other Federal agencies in coping with severe demands on the Nation's fiscal resources, sustaining all of our current customer services becomes increasingly difficult in the long term, given the vast and aging infrastructure needing care and attention. As stewards of a diverse and widespread complex of water resources projects, the Corps of Engineers is challenged to ensure the continued flow of benefits that are so critical to our Nation's security and economic well being.

As I reported to this Committee in the fiscal year 2002 appropriation hearings, we still face a growing maintenance backlog. Routine maintenance, major repairs, replacement of outdated or worn facilities, management improvement studies, and correction of environmental deficiencies could use much more than the budget amount. However, to be realistic in our assessment, we normally focus on critical maintenance. Critical maintenance is maintenance that should be performed in the budget year in order to continue operation at a justified level of service and to attain project performance goals.

The funds provided for fiscal year 2002 left us with a critical maintenance backlog estimated at $702 million, and we estimate that our critical maintenance backlog in fiscal year 2003 will be about $884 million. The critrcal maintenance backlog for navigation is $587 million and consists largely of dredging and repairs to structures such as locks, dams, breakwaters, and jetties. The critical maintenance backlogs for other business functions are $127 million for flood damage reduction, $110 million for recreation, and $60 million for environmental management, and consist of work such as spillway repairs, seepage control, embankment toe protection, access road and recreation facility repairs, and environmental compliance actions. The critical maintenance backlog for hydropower will be eliminated in fiscal year 2003 in conjunction with the Administration's proposal that Federal power marketing administrations directly finance hydropower operation and maintenance.

The critical maintenance backlog includes $93 million for maintenance of shallow draft harbor projects and $108 million for maintenance of low commercial-tonnage inland waterway projects. Most of this work is for purely recreational harbors and higher-cost inland waterway segments and therefore is low priority work.

To improve our program execution, my Division Commanders are continuing a concerted effort to identify and concentrate available resources on the most critical of this work and to do this work at least cost. We are analyzing the work in this backlog to ensure that it qualifies as critical maintenance. In addition, we will continue to assess the justification for the level of service that we are providing. These analyses may result in a slight reduction in our estimate of the critical maintenance backlog for fiscal year 2003.

HOW THE CIVIL WORKS PROGRAM PROVIDES SUPPORT TO THE NATION'S ECONOMIC SECURITY

The Civil Works program employs nearly 25,000 full time equivalent Federal employees and many thousands more private sector contract employees. These individuals are employed in a wide array of fields including all aspects of engineering; architecture; project management; construction management; planning; program management; operation and maintenance; economics; and environmental sciences.

The Civil Works program provides the infrastructure to support important economic activity. The components of the program include navigation features, which facilitate domestic and foreign commerce, flood control features, which reduce flood hazards and damages, water supply to millions of citizens as well as industrial firms, businesses, and farms, hydroelectric power generation features at 75 Corps operated facilities, and recreational features at Corps-constructed lakes and shore protection projects.

I would like to discuss in greater detail the economic impacts associated with two of these areas of activity: navigation features; and recreational opportunities at Corps-constructed lakes.

THE SIGNIFICANCE OF NAVIGATION TO THE NATION'S ECONOMIC ACTIVITY

Commercial navigation is one of the Civil Works program's high priority missions and a focal point for a substantial amount of the Civil Works budget. In the year 2000, over 2.4 billion tons of foreign and domestic cargo were transported via our Nation's ports and waterways. This figure is composed of 1.4 billion tons of foreign trade cargo and 1 billion tons of domestic cargo.

Of the 1.4 billion tons of foreign cargo, almost 1 billion tons were foreign imports to the United States, including over 500 million tons of crude petroleum and 130 million tons of chemicals and related products. Over 400 million tons of cargo were United States exports to other nations, including over 150 million tons of food and farm products, 60 million tons of coal, 58 million tons of chemicals, and 56 million tons of petroleum products.

Of the 1 billion tons of domestic cargo, almost 630 million tons, or 8 percent of the Nation's freight tonnage, moved on the Nation's 11,000-mile inland waterway system. Of the nearly 630 million tons, coal comprised about one quarter of the total with 160 million tons moved, petroleum products totaled 121 million tons, food and farm products totaled 90 million tons, and sand, gravel and stone made up about 80 million tons.

Over 225 million tons of domestic cargo moves via coastwise shipments, including 115 million tons of petroleum products and 48 million tons of crude petroleum such as Alaskan crude petroleum moving to refineries on the West coast of the United States.

Over 114 million tons of domestic cargo moved via shipments on the Great Lakes, including 57 million tons of iron ore and scrap metal, key components in the manufacturing of steel, 30 million tons of sand, gravel and stone, and 20 million tons of coal.

In its 1999 report to Congress, "*An Assessment of The United States Maritime Transportation System*", the United States Department of Transportation reported that waterborne cargo movements created employment opportunities for more than 13 million individuals. While many jobs created are directly in water transportation and ports, most of the 13 million jobs created as a result of waterborne transportation are in other sectors of the economy.

Although there are a number of actors, public and private, that contribute to waterborne transportation, the Corps of Engineers plays a key role. We create and maintain economically justified navigable capacity. We enable the ports and waterways to handle the vessels. Without this capacity, the Nation cannot compete for trade, cannot move goods efficiently, and cannot sustain those 13 million jobs.

RECREATIONAL OPPORTUNITIES AT CORPS CONSTRUCTED LAKES

I will now turn my remarks to the subject of the economic impacts associated with the provision of recreational opportunities at Corps constructed lakes. The Operation and Maintenance, General budget includes $277 million for recreational activities, slightly above the fiscal year 2002 enacted level.

I quote from our recently completed report, "*A National Dialogue About America's Water Resources Challenges For the 21st Century: National Report on Identified Water Resources Challenges and Water Challenge Areas*."

"When it is time for outdoor recreation Americans head for the water. The Nation's many lakes, rivers, and beaches offer everyone fun, fitness, rest and relaxation. Water is the number one recreation attraction in America today, making Federal lakes an irreplaceable public resource."

America's first choice for water-based recreation is the Corps of Engineers. One out of every ten Americans will visit a Corps lake this year.

I would now like to provide you with some figures describing the Corps recreational features at our lakes. The Corps operates 456 lakes in 43 States with a total land area of 12 million acres. At these facilities there are 56,000 miles of shoreline, 4,000 recreational areas with 101,000 campsites, 3,800 boat launch ramps, and 5,000 miles of trails.

Not only is recreation important to the individuals who visit our lakes and other recreational facilities, but also it is important for the economic impacts and employment opportunities created within those communities located near to these recreational facilities.

For example, a 1996 study prepared by the Corps Engineering and Research Development Center, entitled "*Estimating the Local Economic Impacts of Recreation at Corps of Engineers Projects—1996*" concluded that visitors to Corps facilities spent approximately $6 billion on trip related expenses, which in turn generated over 160,000 jobs in the surrounding communities. Significant economic and employment impacts associated with our recreational facilities were identified in a number of geographic locations, including our Little Rock, Nashville, Mobile, Tulsa, Huntington, Louisville, and Fort Worth District offices.

CONCLUSION

We must continue to find ways to reduce our costs and shift some costs to direct beneficiaries of our services. Meanwhile, we will do our very best to execute the Civil Works Program for maximum benefit to the Nation. I have testified today on the positive effects of the Corps mission on the Nation's economy. In closing, I would like to restate that the Corps of Engineers Civil Works program supports economic activity, prosperity, and well being in its high priority mission areas by facilitating waterborne transportation and reducing the threat of flooding and the extent of flood damages incurred, as well as other Civil Works activities.

Thank you Mr. Chairman and Members of the Committee. This concludes my statement.

Chairman CONRAD. Thank you. Thank you for your testimony.

Let me turn first to Ms. Peters, if I could. You said in your testimony, and I quote, "The calculation of the highway funding adjustment is not a policy call. It is a calculation based in law and reflected in the budget."

Let me just say I do not agree with that. I think it is a policy call. Let me ask you this: there is nothing in the law or in the Budget Act, that prevents the President from adding to highway funding that is called for in TEA–21, is there?

Ms. PETERS. Mr. Chairman, the Assistant Secretary will take the question.

Ms. MCLEAN. Thank you, sir.

I think that the situation is that the law specifically articulates what calculation is to be included in the President's budget. It does—

Chairman CONRAD. That is not my question.

Ms. MCLEAN. It does specify—

Chairman CONRAD. My question is very clear. There is nothing in law that prevents the President from adding to the funding base in TEA–21, is there? Would it be illegal for the President or for this Congress to add money to highway funding?

Ms. MCLEAN. No. If funding was added to highways, in the form of an increase in obligation limitation, as has been proposed both in the House and the Senate, the calculation that is required in TEA–21 reduces the firewall, the protected funding in Highway. Any funding above and beyond what is part of the calculation that reduced the obligation limitation would be above and beyond the firewall, so those outlays would have to either displace funding that is in the budget elsewhere, or would add to a deficit situation.

Chairman CONRAD. There are other ways to pay for things, right? I mean those are not the only ways to pay for things. Now, you have only given two. There is other ways to pay for things, is there not?

Ms. MCLEAN. Yes, sir.

Chairman CONRAD. So those are not the only two ways to pay for things.

Ms. MCLEAN. Yes, sir. I suppose you are implying an increase in taxes perhaps or—

Chairman CONRAD. I am just saying there are more than one way to bell this cat. There are more than two ways to bell this cat. And to suggest that this was not a policy call, to me is just not accurate. It is a policy call. The President has said to this Congress, "Cut highway and bridge funding in this country by nearly $9 billion." That is 27 percent. Now, to suggest that is just a matter of law is just not true. The President could have determined to supplement the budget to make up for these dramatic cuts. We are talking about cutting road building and bridge building in this country 27 percent.

Do you have any idea what the job loss would be associated with that, may I ask, Ms. Peters?

Ms. PETERS. Mr. Chairman, yes, I do.

Chairman CONRAD. What would the job loss be associated with that?

Ms. PETERS. Well, let me give you some figures. When we look at Federal funding, $1 billion in Federal funding equates to approximately 38,000 jobs in the market. That is strictly Federal funding. However, that funding is spent out over a period of time.

Generally speaking, the capital outlay on Federal aid programs occurs on average 27 percent in the first year, 41 in the second year, 16 in the third year, 10 percent in the fourth year, et cetera. So that money spends out slowly over time.

If we look at the actual reduction in outlays between fiscal year 2002 and fiscal year 2003, we are looking at less than a 3 percent reduction in capital outlay because of that slower spending over time. That equates, Mr. Chairman, to just under 19,000 jobs between 2002 and 2003 using the baseline that I spoke to earlier, the 38,000 jobs per billion dollars of Federal funding.

Chairman CONRAD. Well, we are talking here about $8.6 billion less for highways and bridges in fiscal 2003; is that correct?

Ms. PETERS. Mr. Chairman, that is correct, but again that money does not all get spent in—

Chairman CONRAD. Right. It has a spend out over a number of years.

Ms. PETERS. That is correct.

Chairman CONRAD. But if we used your formula, $8.6 billion, and we applied for every billion, 38,000 jobs, that would be over 350,000 jobs affected over time. Would that not be the case?

Ms. PETERS. That is accurate, sir.

Chairman CONRAD. So I mean at the time we got the Administration calling for a stimulus package to provide more jobs, the President gives a speech saying his focus is jobs, he sends up a budget that cuts 350,000 jobs, and at the same time damages economic efficiency of the economy because it leads to more gridlock.

Have you seen the calculations of the cost to the economy of gridlock on the highways, Ms. Peters?

Ms. PETERS. Yes, sir.

Chairman CONRAD. And what are those calculations?

Ms. PETERS. Sir, I do not have the numbers with me today. I do know that gridlock or congestion is detrimental to the economy. But I think the point is that the President's budget followed the formula that was specified in TEA–21. We certainly are mindful of the impacts of congestion and of not putting forward transportation projects but, as the Assistant Secretary said, these are unusual times. These are difficult decisions that have to be made by our country in these times of unprecedented issues.

Chairman CONRAD. Well, are you saying, as the Highway Administrator, that you do not think this budget should be added to? Do you think it would be irresponsible by the Congress to add the funding for highways and bridge construction in this country?

Ms. PETERS. Mr. Chairman, I would never call the members of Congress irresponsible.

Chairman CONRAD. Well, I am asking a specific question. Do you think adding to the funding for highway and bridge construction in this country would be irresponsible?

Ms. PETERS. No sir, I do not think that would be irresponsible.

Chairman CONRAD. Do you think it would be the right thing to do?

Ms. PETERS. Mr. Chairman, again, I think we have to weigh competing priorities in a variety of areas. If I would look at this strictly as the Federal Highway Administrator, certainly I see the value in increasing highway funding. But what the Administration has to look at are the competing demands for funding across a broad range of important—

Chairman CONRAD. Well, that is what Congress has to do too, Ms. Peters, and I think you see overwhelmingly Congress is saying the Administration's proposal here does not make a whole lot of sense. You are talking about cutting highway and bridge funding 27 percent, affecting over 300,000 jobs at a time when the President is calling for more jobs. I mean this is a contradictory policy that makes no earthly sense, does not make any sense to the governors, does not make any sense to the people of Congress, to come in here and talk about a 27 percent cut, and say, "Well, it is not our fault. It is immaculate conception." This just came out of a formula. Budget is not immaculate conception. It is choices. And the President has chosen to cut highway and bridge funding 27 percent.

I cannot find much of anybody who agrees with it, not on an economic basis, not on terms of strengthening the economy, not in terms of keeping the commitment that the States thought had been made to them under TEA–21. I tell you, I find very little support for what the President has sent us.

Let me, if I could, go to you, Mr. Parker. How much was the budget authority for last year that was enacted by Congress for the Corps; do you recall?

Mr. PARKER. 4.6 billion.

Chairman CONRAD. That is my number as well. $4.6 billion. What has the President proposed?

Mr. PARKER. Well, when you look at the basic number, it is 4.3. However, when you do put the adjustments in for retirement, security, you come back down close to the $4 billion that was proposed last year.

Let me just point out the way that—this is the way—you know I just came on board in October. And what I did is I got with my staff, and I said, "You tell me. I want you to put together what could we do in all the projects that we have going on in this country, in a utopia, taking out the discussion of September the 11th, just in a utopia, what could we do to maximize our total program?"

That figure we came up with was around $6.4 billion. That would be the most that we could do. We could prioritize, we could do all kind of things as far as the construction backlog and everything. That is what we went to OMB with.

Chairman CONRAD. That is what you requested?

Mr. PARKER. Yes.

Chairman CONRAD. $6.4 billion?

Mr. PARKER. Right.

Chairman CONRAD. And you got, on a comparison basis, 4.

Mr. PARKER. But we knew full well that that was as much as we could ever get. I mean that was the most we could ever utilize. We also knew that that amount would come down, and it should come down. I mean if we knew that—especially in this day and time things would—

Chairman CONRAD. Well, did you think 4 billion was the right number to come to?

Mr. PARKER. No. I would have offered that number if I thought it was the right number.

Chairman CONRAD. Okay. Let me ask you this. How big is the backlog?

Mr. PARKER. Well, it depends on what you are talking about. The backlog on maintenance has now increased to around, it will be around 900 million, and the longer we put it off, the more that it will increase.

Chairman CONRAD. Yes. I have got the maintenance backlog as 884 million?

Mr. PARKER. Right.

Chairman CONRAD. Is that correct?

Mr. PARKER. Right, $900 million.

Chairman CONRAD. And if we were to look at all the projects that are under way around the country, how big a backlog would that represent?

Mr. PARKER. If you looked at all the projects in total, you would be talking about $44 billion.

Chairman CONRAD. $44 billion. Let me ask you this. You have had, last year there was $4.6 billion. The President cut that by 600 million on a fair comparison basis to $4 billion. What are the implications of those reductions? What would it mean? I am told that it could require the agency to terminate ongoing project contracts prematurely, resulting in an estimated $190 million loss. Is that correct?

Mr. PARKER. Let me, if I could, let General Flowers answer that question.

General FLOWERS. Yes, sir. With the budget as it stands, we would in fact have to terminate projects.

Chairman CONRAD. What would that mean?

General FLOWERS. Would be about $190 million is what it would cost us, roughly, to terminate those projects. And the resulting job loss could be in the neighborhood of 45,000 jobs.

Chairman CONRAD. Why would you have to terminate ongoing projects? Why would you have to terminate contracts that are already in place?

General FLOWERS. Sir, based on the contracts that we have in force and the amount of money which has been budgeted for our construction general account, there is not enough to keep all projects going. And what we would find ourselves doing is keeping in force contracts, and operating them at about below 50 percent efficiency, and having to terminate those other contracts for the cost that I mentioned earlier.

Chairman CONRAD. So you would have no choice but to terminate contracts?

General FLOWERS. Yes, sir, that is correct.

Chairman CONRAD. And then you would have to pay termination fees, I take it?

General FLOWERS. Yes, sir. The costs that I mentioned are in fact the termination fees, an estimate of termination fees.

Chairman CONRAD. So we would be spending several hundred million dollars and not getting anything for it?

General FLOWERS. That is correct, sir.

Chairman CONRAD. It does not sound like it would make much sense to me. Does it make much sense to you, General Flowers? Knowing what those projects are, would it make any sense to you to terminate these projects?

General FLOWERS. Sir, it does not. I think one has to look at the President's stated objectives and what the Corps I think can bring to help fulfill those objectives. And I would submit that in combatting the war on terrorism and providing homeland security, the work that we do in maintaining strategic ports is very vital to the military effort as well as to the economy, because about 98 percent of our foreign commerce is seaborne.

Chairman CONRAD. How much? Can you repeat that?

General FLOWERS. About 98 percent of our international commerce is seaborne.

Chairman CONRAD. So this has a security issue attached to it.

General FLOWERS. Sir, I believe it does. We have traditionally, in the United States Army Corps of Engineers, I think contributed to the national defense.

And if I could, I would just like to cite a quote from President Eisenhower, when he was testifying on the civil works functions of the Army, because we quite often get asked why are civil works in the Army. And his quote was that operations in New Guinea were conducted in wild virgin territory. He talked about a number of facilities that had to be built in places where nothing existed, and the war in the South Pacific being an engineer war.

And his quote was: "I am firmly convinced that but for the existence of the Corps of Engineers peacetime organization and its resources of men, methods, training and supply, its close association with the military through the years, the history of the Pacific area in World War II would have been written more in blood than in achievement."

And so we pride ourselves on helping our national security, and at the same time being able, through the application of our projects, in having a positive effect on the economy, not just in the jobs created by the construction themselves, but in benefits that are returned to the treasury that come from our projects.

Chairman CONRAD. Let me go to a specific example if I could that is in my State—Grand Forks, North Dakota, the place that suffered these disastrous floods in 1997. There is a project under way there that is a partnership between the State, the local community and the Federal Government to build protection for the community so that it would never suffer that disastrous impact again, when we had 98 percent of the community evacuated, the biggest mass evacuation since the Civil War. This is a town of about 50,000 people. The Federal Government, to fix up the mess, spent $700 million in that town, $700 million. Now, none of us ever want to see that happen again. And so a dike is being constructed. What is in the budget for that dike? Do you recall?

General FLOWERS. Yes, sir. We have $30 million in the fiscal year 2003 budget for the flood protection at Grand Forks.

Chairman CONRAD. And what could you realistically use to improve the flood protection? In other words, how much money do you need to make maximum progress on providing flood protection for that community?

General FLOWERS. Sir, full capability would be $75 million.

Chairman CONRAD. $75 million. So this is one example of many of where you have insufficient resources to do something that everybody who has been involved in the challenge agrees needs to be done.

General FLOWERS. Yes, sir.

Chairman CONRAD. I do not know of anybody that says do not provide flood protection to that community. Certainly the Governor of our State believes it is a priority. The local community, I was just with the mayor of that town, they believe it is a priority, and they have put their money where their mouth is. The State has put up money. The local community has put up money, and a lot of money for a community like that, and a lot of money for a small State like mine. And yet we are not making the progress that we could make to provide flood protection. Let us just all hope, keep our fingers crossed, there is no flood there in the meantime while we are waiting to get this job done.

Let me turn to my colleague, Senator Murray, for questions that she might have.

Senator MURRAY. Well, thank you very much, Mr. Chairman, for having this hearing on two issues that really are important to the economic success of our country and the renewal of our economy that we need, both education and transportation. And unfortunately, I cannot stay for the second panel and third panel on education.

So I just wanted to make a comment that last year Congress passed and the President signed the ESEA reauthorization, and that bill had two parts. On one hand it called for higher standards and accountability. On the other hand it promised more investments so our schools could make progress.

Well, here it is just a few months later, and already the President's budget has pulled rug out from under our students by reneging on that promised investment. This budget that has been presented to us cuts funds for teacher quality. It cuts class size reduction activities. It freezes funding for after-school programs and safe and drug-free schools. And it does not fully fund our share of special education costs, failing yet again to fulfill that commitment to our communities, our schools, and our disabled students.

Mr. Chairman, we know the needs are out there. We know what works to help our children succeed, and we know that this budget does not do enough to help. So I just wanted to make that statement since I cannot be here, and I am extremely concerned about what the President's budget does in terms of education after all the rhetoric that we heard on the Elementary and Secondary Education Act that just passed.

But the other area that I am deeply concerned about as well is the transportation issue. Mr. Chairman, in my home State we just found out that we are at over 8 percent unemployment. We also have the second worst traffic in the entire country. Transportation is a crisis in the State of Washington, and investment in transportation is a crisis across the country.

Now, we all know that when we invest in infrastructure, it pays dividends for our communities. Better roads and highways mean less time in traffic. It means greater productivity and greater quality of life. But, Mr. Chairman, as you pointed out, it creates jobs. At a time when our economy is floundering, it is especially important that we invest in these infrastructure jobs and not pull the rug out from under all of these projects across the country. This $8–1/2 billion cut will mean, as you pointed out, 350,000 jobs lost across this country. That is going to have an incredible economic impact.

Now, Mr. Chairman, I would like to insert into the record a list of what this cut means to every single State. I think you will find it especially interesting, but I will summarize it with just one statistic for this Committee. If we just look at the States that are represented on this Budget Committee, the communities represented right here will lose more than $3 billion in infrastructure investments.

Now, Mr. Chairman, when the President's budget director was here, Mitch Daniels, he told us that the Administration was only following the requirements of the TEA–21 law, and I think I heard that again this morning. But what Mr. Daniels really failed to tell us is throughout his budget proposal, there are hundreds of examples where the Administration is asking us to ignore existing law or to change the law. Just within the transportation budget we are asked to ignore current law and to adopt measures to throw out several communities out of the essential air service program. And we are asked to ignore the TEA–21 law and divert transit formula funds to the President's new freedom initiative. We are also asked to ignore current law and impose new user fees on railroads, shipping communities and transportation of hazardous materials. Mr. Chairman, we are also asked, in the President's budget, to ignore TEA–21 law and lower the Federal cost share for major transit projects.

So to me, what the Administration wants to do is to change the law dramatically in many areas, but uses the law as an excuse for cutting highway funds.

So, Ms. Peters, I would just like to ask you why the Administration supports current law when it required billion dollar cuts in infrastructure, but it ignores current law in so many other places?

Ms. PETERS. Mr. Chairman, Senator Murray, I am going to defer to the Assistant Secretary in terms of the compilation of the President's budget, but let me say this first. I have been a State transportation director. I spent the last 17 years of my life as director of the State Department of Transportation in Arizona, and I do understand the difficulties that are faced by this Nation and by States such as yours that are experiencing high growth and have significant transportation demands. And we are certainly willing to work with you and members of Congress on this issue.

But the point is, and I think the important point is, there were many, many difficult choices to make in this budget, difficult choices that you face as well, and again, let me defer to the Assistant Secretary for a direct answer.

Ms. MCLEAN. I think you are absolutely right, that the proposed budget includes some suggestions and changes in law. In this case we felt like we should not abandon the adjustment that was in TEA–21. The concept of linking highway spending to receipts is a sound one. It is a fundamental principle of TEA–21, and on the eve of reauthorization we did not believe that moving away from this principle was the right approach.

However, as Administrator Peters mentioned and Assistant Secretary Parker mentioned, the formulation of the President's budget this year is extremely difficult. You have a situation where you need to fund, obviously, the Defense Department in the situation that we are in a war. Plus defending terrorism, we have a significant increase in the Transportation Security Administration (TSA) funding for transportation security issues. And in this case, we followed the TEA–21 formula for this adjustment.

Senator MURRAY. Well, I appreciate the choices that are made, but I do not think it is fair to say that the $8–1/2 billion cut is a policy call, when in fact many other places in the budget, the President does ignore, or asks us to ignore existing law. So using the existing law as an excuse for the $8–1/2 billion cut does not carry with me.

What is the Federal Highway Administration going to do to lessen the impact this cut will have on States? I especially want to know about 2004 and beyond.

Ms. PETERS. Thank you. Senator Murray, there are several things that we can do to work with the States. As I mentioned, overall we are seeing a spending outlay difference between 2002 and 2003 of about $500 million. Methods that we stand ready to work with the States on, in terms of addressing those issues, are using features such as advance construction, moving projects forward, and then repaying that—

Senator MURRAY. What do you mean by advance construction? You are going to ask States to pick up the cost till we come back around and pay for them?

Ms. PETERS. Senator Murray, that is accurate. State or other funds would be used, or perhaps—

Senator MURRAY. I would just point out, Ms. Peters, that sounds really good, but my State has to cut a billion and a half dollars out of a $20 billion budget that they currently have because of the economic conditions in my State right now. I cannot tell them, "You pick up the money right now. Trust us. Kent and I will be back here in a couple years, and we will come through with the money for you." That does not work.

Ms. PETERS. Mr. Chairman, and Senator Murray, I do understand that States are undergoing very difficult issues right now. There are other tools that we can use to move projects out over time—though clearly that does delay the completion of the projects. But that is an option.

Senator MURRAY. And costs more.

Ms. PETERS. There is also the ability to use unobligated balances on other projects that we might be able to move forward in a shorter term. Again, as I said earlier, I do understand these issues. I have worked with the director of transportation in Washington State, and do understand your issues. We will work with you, both in terms of what Congress chooses to do with this, and working with the States to help mitigate the effect of this over time.

Senator MURRAY. Well, Mr. Chairman, I would just say that we have been handed a really difficult situation, where we have been given an $8–1/2 billion cut that is going to have an extreme impact on our economy which cannot take it. It will have an impact on our future ability. Our States cannot make up these or future any of this, and I hope we do not see finger pointing at the end of the time here where the President says, "See that, Congress goes and spends money," because the choice came in his budget when he cut $8–1/2 billion, and I do not want us to be holding the bag at the end of the day, but it looks like that is what he has given us.

Chairman CONRAD. All right. I think it is very clear, this is budget rope-a-dope. We all know what is going on here. They know exactly down at the other end of Pennsylvania Avenue, that Congress is not going to cut highway and road-building projects across the country by 27 percent. It would not be the responsible thing to do.

Frankly, we have had little talk about responsibility. I think this budget submission on highway and road building is irresponsible, irresponsible with respect to the jobs that it would kill, over 350,000 jobs over the life of these projects that would be lost makes absolutely no sense at a time of economic weakness, makes absolutely no sense in terms of the gridlock that we see in the transportation systems of the country.

Recently I was out to visit Admiral Owens, a former vice chairman of the Joint Chiefs of Staff that now lives in Seattle. And I saw there firsthand the gridlock. Trying to go to the airport, I mean that road is stopped dead, and it is not stopped dead the 5 o'clock, it is stopped dead at 4 o'clock in the afternoon. And it happened to me three times out there on that road.

I just think we all know what is going on here. They know full well this funding is going to, at least in some measure going to be restored, and then they are going to turn around and say, "There go those spenders down in Congress." I just think it is kind of a tired old game that is being played here.

And the same with the Corps. Cutting the Corps below the amount of money they had last year, so as to actually require terminations of projects that are currently contracted for, does not make any sense. General Flowers does not think it makes any sense. I do not think it makes any sense. But this is more rope-a-dope. And, you know, it is kind of a clever game, but it is tedious and it is silly.

And if there is anything that is clear, Congress is not going to be terminating contracts that are under way. That is irresponsible. Congress is not going to cut 27 percent from highway building and bridge building and cut 350,000 jobs at the same time the Administration's asking us for a stimulus package to generate jobs. Does anybody connect the dots down there on these kinds of questions? I do not know. Apparently not.

But I would again thank the witnesses. We appreciate your being here. We have a second panel, and we will go to them next, but first let me just say this to you. Mr. Parker, we want to work with you and General Flowers to create a budget here that does make sense. We do not want you terminating contracts. We do not want you to be in that position. We want to help you work off this backlog, the maintenance backlog as well as the construction backlog. Obviously, we are under very severe constraints, but we are not going to have less money this year than last, when last year was insufficient to whittle down that backlog. That would just be penny wise and pound foolish. It would mean more cost. I know that with these construction projects, designed for flood control, waiting, stretching it out means it costs more money. We are not going to do that.

And we do not have the luxury of doing all that could be done or should be done. We understand that. We are going to have to be very tough on the bottom line, but I do pledge to you this Committee is going to work closely with you, and I ask you to work with us. Will you do that, Mr. Parker, help us identify how we can construct a budget number here that does meet the needs and will avoid contract terminations?

Mr. PARKER. The Administration will work with you on that, totally.

Chairman CONRAD. I look forward to that.

And I say the same thing to Ms. Peters. We are not going to be cutting $8.6 billion around here. There is no support for that. I have not talked to a single member on the House or the Senate side that thinks that that is a responsible thing to do. So I would ask you as well, will the Administration work with us to try to come together around a fiscally-responsible plan that does not have a 27 percent cut in highway and bridge building?

Ms. PETERS. Mr. Chairman, the Administration is always pleased to work with Congress, and we will work with you on these issues.

Chairman CONRAD. All right. We look forward to that, and I again thank the witnesses for being here.

Now we will go to our second panel.

On our second panel, we are going to be talking about education. We have Bob Chase, the president of the National Education Association; Larry King, the secretary of the American Association of State Highway and Transportation Officials; and Thomas Till of the Amtrak Reform Council.

Welcome to all of you, and why don't we start with you, Mr. Chase, on the subject of education.

STATEMENT OF ROBERT CHASE, PRESIDENT, NATIONAL EDUCATION, ASSOCIATION

Mr. CHASE. Thank you very much, Senator. On behalf of the NEA and our 2.7 million members, I want to thank you for the opportunity to testify today on the fiscal year 2003 education budget and would like to request that my full statement, along with the attachments, be made part of the record.

Chairman CONRAD. Without objection.

Mr. CHASE. Thank you.

NEA members represent the full diverse spectrum of public education. We are elementary and secondary teachers, para-professionals, vocational educators, as well as post-secondary education faculty. We are deeply committed to strengthening our education system to guarantee a quality public education for every student. The NEA believes that an effective, successful public school system must include, among other things, a highly qualified teacher in every classroom, rigorous academic standards for all students, strong accountability measures, small class sizes, and modern, safe school facilities with access to new technologies for all students. We also believe that all qualified students should have access to post-secondary education and have access to the financial resources and academic supports they need to succeed.

However, ensuring the highest quality education for all students is not possible without significant Federal investment. Simply put, reform without resources will not work. A strong Federal commitment to education funding is made even more critical today by current State budget pressures and new Federal mandates. These crises, coupled with rising school enrollments and the increased numbers of students with special needs, have already led to many State's cutting critical education programs.

At the same time, States face new testing and accountability mandates under the newly enacted No Child Left Behind Act, or ESEA, most of which will become more challenging each year. Without a substantial increase in resources from the Federal level, many of the important goals of the new law, including yearly improvements in student achievement and in teacher quality, will simply be impossible to reach.

NEA applauds the bipartisan commitment to education investment over the last 6 years. Increases have averaged approximately 13 percent a year. Now we urge Congress to continue on this path by providing immediate investments for key programs such as Title I and IDEA, but not at the expense of other important education programs.

While the Administration's proposed fiscal year 2003 budget includes some important programmatic increases, overall it offers the smallest percentage of dollar increases in education funding since 1996. At the Administration's proposed fiscal year 2003 level, many important programs will be unable to serve eligible students, and successful implementation of new reforms and mandates will be very difficult to achieve. Therefore, we urge Congress to use the budget request as a base—as a base—on which to build toward needed investments.

First, NEA opposes the Administration's proposal to pay for needed Pell Grant supplemental appropriations by eliminating current funding for 29 elementary and secondary education programs. We completely agree that a supplemental Pell Grant appropriation is necessary and important. However, we strongly oppose pitting higher education against elementary and secondary education or pitting any one education program against another.

In terms of the coming fiscal year, we commend the Administration for proposing increases in Title I and in IDEA and also providing an important $1 billion for Reading First. But we are deeply concerned that the budget would essentially pay for most of these increases by eliminating 40 other programs, freezing funding for 66 programs, and cutting funds for an additional 16 programs.

Overall, the Administration would cut funding for ESEA programs, reauthorized less than 2 months ago, by $90 million. These cuts will undermine efforts to implement the 6 years of new reforms and requirements in the No Child Left Behind Act, thereby setting children, schools, and States up for failure.

Instead of cutting funds, Congress should commit to yearly increases to help States and schools successfully implement reforms. For fiscal year 2003, NEA recommends that Congress provide at least a $12 billion increase above the Administration's budget for education programs. Specifically, NEA's priority includes:

Title I, where we believe that the Administration's proposed $1 billion increase offers a good starting point, but still falls far short of what is needed. The Administration's proposal falls $4.65 billion below the fiscal year 2003 level authorized in the new law, a level that was adopted on a bipartisan basis through the efforts of Senators Dodd and Collins. Keeping Title I on track toward full funding is particularly important given the new accountability and adequate yearly progress provisions in the new law. As these new requirements tighten each year, the number of schools deemed in need of improvement will likely increase. All of these schools will need assistance. Simply placing them on a list and labeling them will not magically produce results. Therefore, NEA urges Congress to fully fund the authorized level of $16 billion for Title I in Fiscal Year 2003 and to provide $500 million for the school improvement fund to help turn around low-performing schools.

Secondly, IDEA. The Administration has also proposed a $1 billion increase for IDEA, or special education. Again, while we certainly applaud this proposal as a good starting point, we believe it falls short of what is needed. Providing a quality education for all students, including those with disabilities, requires a Federal–State-local partnership. Today's States and localities simply cannot provide students with disabilities the quality of services they need, and often must cut other critical programs or raise taxes in order to provide mandated services.

Students with disabilities and their families deserve more than an empty promise. Therefore, NEA urges Congress to provide a fiscal year 2003 increase of $2.45 billion for IDEA and to guarantee similar increases for each of the next 6 years, as in the bipartisan Harkin–Hagel amendment passed by the Senate last year.

The third area, teacher quality. Research clearly—

Chairman CONRAD. Could I just stop you on the last point?

Mr. CHASE. Yes, sir.

Chairman CONRAD. Just more broadly, I should say we are not going to be able to do a $12 billion increase. We have been going over this budget. I think what you are asking for is completely understandable, given the need. I can tell you in terms of the enormous pressure we are under, because of the downturn and the attack on September 11th, and because of the tax cut passed last year, which is the biggest reason for the disappearance of surpluses, that we are not going to be able to accommodate an increase of that magnitude.

But I am very interested in what your recommendation is on IDEA specifically. As I heard you say, you are proposing a $2.45 billion increase for IDEA.

Mr. CHASE. That is correct.

Chairman CONRAD. And with a commitment for that amount for the next 6 years?

Mr. CHASE. Over the next 6 years. That was the bill that was passed last year, the Harkin–Hagel amendment passed by the Senate last year, to fully fund IDEA over a 6-year period. I am sure you recall that 27 years ago, when IDEA was first enacted, there was a promise made by Congress at that time that the Federal Government would fund 40 percent of the costs of mandated special education programs. As of now, it has funded, at the highest point, somewhere between 16 and 17 percent. Certainly an additional 24 percent of that funding being provided to State and local governments would free up those dollars at the State and local level to be spent on other very needed education programs.

Chairman CONRAD. I do think there is a clear Federal obligation. I believe the commitment was to 40 percent funding. We have not kept it. That has put enormous pressure on school districts all across the country.

Would you think that the single most important thing we could to help school districts across the country would be to keep the Federal promise on IDEA?

Mr. CHASE. I am not sure, Senator, if I would say it is the single most important, but it certainly is a critical one. I think Title I funding is also critically important. But if, in fact, the commitment made to fully fund IDEA was met, it would make an enormous difference to State and local efforts as far as public education is concerned.

Chairman CONRAD. If Congress were to start down the path of meeting the obligation—and you added that roughly $2.5 billion a year for 6 years—at the end of that time do your calculations show we would meet the 40 percent promise that was made?

Mr. CHASE. Yes, sir.

Chairman CONRAD. So it would be at the end of that period—

Mr. CHASE. At the end of 6 years.

Chairman CONRAD [continuing]. That we would then be at the 40—

Mr. CHASE. That is correct.

Chairman CONRAD. Okay. I appreciate that, and I am sorry for the interruption. But I wanted to make certain that we got that on the record.

Mr. CHASE. Thank you.

On the teacher quality issue, research clearly demonstrates that the presence of a highly qualified teacher in a classroom is the most critical element in raising student achievement. The new ESEA law creates new teacher quality requirements, mandating that all teachers be highly qualified within 4 years. At the same time, States are facing teacher shortages caused by record enrollments and the projected retirements of thousands of veteran teachers.

The combination of new teacher quality requirements and a teacher shortage necessitates an increased investment in teacher recruitment and in professional development programs. Although the President in his State of the Union speech recognized the need to recruit more highly qualified teachers in the coming years, the Administration's fiscal year 2003 budget freezes funding for teacher quality and eliminates funding for the National Board for Professional Teaching Standards and teacher technology training. Clearly, this proposal is at odds with the goal of improving teacher quality and ensuring every student has a highly qualified teacher.

We recommend a $1 billion increase for Title II, teacher quality. The math-science partnership program should be funded at its authorized level of $450 million. We also strongly recommend retaining funding for the National Board.

I would also like to briefly mention school modernization. Another critical component of raising student achievement is ensuring every student a safe and modern learning environment. America frankly does not expect corporate executives and employees to work in overcrowded buildings with leaky roofs, crumbling ceilings, faulty heating systems, and go down the list. Yet these unacceptable conditions exist in far too many of the Nation's schools. The fiscal year 2002 appropriations bill eliminated the $1.2 billion urgent school repair program, and the Administration's fiscal year 2003 budget provides no funding for school repair and renovations. We urge Congress to provide $1.75 billion over 5 years to subsidize the interest on school modernization bonds and to provide a $1 billion appropriation for urgent school repairs.

NEA strongly supports the Administration's proposal to provide an above-the-line tax deduction to offset educators' out-of-pocket classroom supply and professional development expenses. We recommend it be expanded to cover such expenses starting with this tax year. In 1996, NEA found that an average K–12 educator spent over $400 a year out-of-pocket for classroom materials, and many spent much more than this. For educators earning modest salaries, such purchases require considerable expenses.

We also support increased investment for rural education, higher education, early childhood education, and a range of other critical programs. These recommendations are detailed in the appendix in my written statement.

Finally, I would like to express our opposition to the Administration's proposal for subsidized tuition tax breaks for private and religious school expenses, a proposal that NEA strongly opposes. The proposal is essentially a voucher proposal, providing direct payment of Federal funds to parents for private and religious school tuitions. It will siphon off $3.7 billion over 5 years from public schools. This funding could be much better spent to help the 90 percent of students attending public schools. Therefore, NEA urges Congress to reject this dangerous voucher proposal and instead to focus on the real reforms that help all students succeed.

Mr. Chairman, thank you very much for giving us the opportunity to share our thoughts with you this morning.

[The prepared statement of Mr. Chase follows:]

THE PREPARED STATEMENT OF BOB CHASE, PRESIDENT, NATIONAL EDUCATION ASSOCIATION

On behalf of the National Education Association's (NEA) 2.7 million members, thank you for the opportunity to testify today about the importance of an increased Federal commitment of resources in building the world-class educational system our children deserve.

NEA members represent the full, diverse spectrum of public education. We are elementary and secondary school teachers, para-professionals, vocational educators, and Post-secondary education faculty. We are deeply committed to strengthening our educational system to guarantee a quality public education for every student.

NEA's vision for quality public education focuses on improving student achievement and elevating teacher quality. NEA believes that an effective, successful public education system must include: a highly qualified teacher in every classroom; rigorous academic standards for all students; strong accountability measures; small class sizes; and modern, safe school facilities with access to new technologies for all students. We also believe that all qualified students should have access to Post-secondary education, and to the financial resources and academic supports they need to succeed.

However, ensuring the highest quality education for all students is not possible without a significant Federal investment. Simply put reform without resources will not work. My testimony today will focus on those Federal investments necessary to ensure successful, meaningful education reform.

THE CONTEXT: STATE BUDGET PRESSURES

The need for a strong Federal commitment to education funding is made even more critical by current State budget pressures and new Federal mandates. A new report prepared for the National Governors Association The Outlook for State Tax Revenues found that "At least forty States are now experiencing budget shortfalls during the current 2002 fiscal year, which ends in June for most States. The miss between actual budget results and that expected when budgets were drafted a year ago is approaching a stunning $40 billion." The report goes on to note, "Longer term, State governments have the daunting task of meeting the rising funding needs of such things as education, public welfare and homeland safety in the face of an increasingly inflexible tax system." In addition, according to a January 2002 survey conducted by the National Conference of State Legislatures (NCSL), Forty-five States and the District of Columbia report that revenues have failed to meet budgeted levels * * * At least 30 States have implemented budget cuts or holdbacks to address fiscal problems in fiscal year 2002. Another nine report that cuts are possible before the fiscal year ends. Most State programs have been affected by budget cuts * * * The magnitude of budget gaps has been significant enough that even programs that often are spared from cuts, such as K–12 education, have been reduced in some States.

These crises, coupled with rising school enrollments and increased numbers of students with special needs, have already led many States to cut critical education programs.

At the same time, States face new testing and accountability mandates under the newly-enacted No Child Left Behind Act, most of which will become more challenging each year. Without a substantial increase in resources from the Federal level, many of the important goals of the new law including yearly improvements in student achievement and teacher quality will be simply impossible to reach.

THE PUBLIC'S VIEWS

The general public strongly supports increased Federal investments in education. A recent poll commissioned by the Committee for Education Funding of which NEA is an active member found that two-thirds of the American public would accept a larger deficit in order to provide improved education for students from kindergarten through college. Similarly, a recent Zogby poll found the public favoring by a 69 to 29 percent margin "rolling back the tax cut if it means the Federal Government has more money available for education."

NEA'S EDUCATION FUNDING RECOMMENDATIONS

NEA believes that significant, targeted Federal investments are necessary to help all students reach the highest standards. To this end, we applaud the bipartisan commitment to education investments over the last six years increases that have averaged 13 percent a year. Now, we urge Congress to continue on this path by providing needed investments for key programs such as Title I and IDEA, but not at the expense of other important education programs.

While the Administration's proposed fiscal year 2003 budget includes some important programmatic increases, overall it offers the smallest percentage and dollar increase in education funding since 1996. In addition, even with the yearly increases in Federal funding for education over the last six years, the Federal share of total education spending is still less than it was in 1980, when the Federal Government provided almost 12 percent of all funds for elementary and secondary education. Last year, the Federal share was down to 8.5 percent. Similarly, the Federal share of higher education funding declined from 15.4 percent in fiscal year 80 to 10.9 percent in fiscal year 2001.

At the Administration's proposed fiscal year 2003 level, many important programs will be unable to serve eligible students, and successful implementation of new reforms and mandates will be very difficult.[1] Therefore, we urge Congress to use the Administration's budget proposal as a base on which to build toward needed investments.

In addition, we urge Congress to reject proposals to freeze funding or eliminate important Federal programs. And, we strongly oppose proposals to divert limited funds away from public schools through voucher-like tuition tax credits.

I would now like to focus my testimony on NEA's general reactions to the Administration's proposal, and our overall recommendations for fiscal year 2003 funding priorities. More detailed proposals for fiscal year 2003 education funding are included in an appendix to this testimony.

OPPOSITION TO FISCAL YEAR 2002 RESCISSIONS

NEA opposes the Administration's proposal to pay for a needed fiscal year 2002 $1.3 billion Pell Grant supplemental appropriation by eliminating 29 elementary and secondary education programs. We completely agree that a supplemental Pell Grant appropriation is necessary and important in order to maintain the $4000 maximum award set by Congress. However, NEA strongly opposes pitting higher education against elementary and secondary education, or pitting any one education program against another. Last year, Congress carefully considered and approved funding on a bipartisan basis for each of the programs marked for elimination. First, Congress explicitly decided to retain authorization for each of these programs as part of the No Child Left Behind Act. Later, Congress again decided to maintain and fund these programs as part of the fiscal year 2002 Labor–HHS–Education Appropriations bill. In fact, many, if not all of these programs enjoyed broad bipartisan support, with Republican Senators acting as the programs main champions in many cases.

Therefore, NEA recommends that Congress enact the Pell supplemental but reject proposed rescissions of fiscal year 2002 funding for elementary and secondary education programs.

FISCAL YEAR 2003 PRIORITIES

The Administration has proposed a $1.37 billion increase for education funding for fiscal year 2003. While, as noted in more detail below, this proposal includes increases for Title I and IDEA, and also provides an important $1 billion for Reading First, the Administration would essentially pay for most of these increases by eliminating 40 programs, freezing funding for 66 programs, and cutting funds for an additional 16 programs.

Overall, the Administration would cut funding for ESEA programs reauthorized less than two months ago by $90 million. These cuts will undermine efforts to implement the six years of new reforms and requirements in the No Child Left Behind Act, thereby setting children, schools, and States up for failure.

Instead of cutting funds, Congress should commit to yearly increases to help States and schools successfully implement reforms.

For Fiscal Year 2003, NEA recommends that Congress provide at least a $12 billion increase above the Administration's budget for education programs. Specifically, NEA priorities include:

- **Title I:** The Administration has proposed a $1 billion (+9.7%) increase in Title I funding for Fiscal Year 2003. This 9.7 percent increase would bring Title I to its highest funding level ever. NEA believes the Administration proposal offers a good starting point, but still falls short of what is needed. We are pleased that the Department of Education has recognized the value of Title I in its fiscal year 2003 Justifications of Appropriations Estimates, which states "* * *there is evidence that Title I, as reauthorized in 1994, helped put in place the infrastructure needed to improve student achievement. This, coupled with the reforms in the NCLB Act, is expected to have a positive impact on the Nation's schools that warrants further investment in the program."

The current Title I authorization levels were adopted last year on a bipartisan basis through the efforts of Senators Dodd and Collins. The Dodd–Collins amend-

[1] To illustrate the unmet needs across the country, NEA has compiled a set of State-specific charts contrasting current funding levels for Title I, IDEA, Head Start, and school modernization with the President's proposal and remaining unmet State needs. These State-specific charts are available on the NEA website at http://www.nea.orgllac/fyO3ed$/. The charts are intended to highlight the need for increased resources, and to set the stage for work over the next few years to address these unmet needs.

ment to the No Child Left Behind Act was intended to put Title I on a ten-year path toward full funding. Unfortunately, the Administration's proposal falls $4.65 billion below the fiscal year 2003 level authorized in the new law.

Keeping Title I on track toward full funding is particularly important given the new accountability and Adequate Yearly Progress provisions in the new law. As these new requirements tighten each year, the number of schools deemed "in need of improvement" will likely increase. Estimates indicate that as many as 10,000 schools will start the 2002–03 school year categorized as "low-performing," based on standards under prior law, All of these schools need assistance; simply placing them on a list and labeling them will not magically produce results. Tragically, approximately one-half of schools identified as needing improvement a year ago received no additional resources or assistance. If our goal is to turn these schools into successful, high-performing institutions, we must provide the necessary funding.

Unfortunately, less money will be available for school improvement in fiscal year 2002 than in the previous year. In fiscal year 2001, Congress earmarked $225 million for school improvement, in addition to a 0.5 percent State set-aside. Thus, a total of $268 million is available this school year. However, while Congress increased the fiscal year 2002 State set-aside to 2 percent, it failed to earmark additional funds for school improvement. Therefore, only $207 million will be available for the 2002–03 school year. In addition, while the new ESEA law authorizes $500 million for school improvement activities in low-performing schools, Congress did not fund this program for fiscal year 2002 and the Administration did not include it in the fiscal year 2003 budget request. A significant increase in Title I is also necessary as, under current law, as much as 40 percent of Title I funds will not be available for classroom instruction. Under the No Child Left Behind Act, portions of Title I funding are earmarked for other purposes including transportation for public school choice, supplemental services, and professional development. While important, these earmarks reduce the funds available for direct instruction.

Therefore, NEA urges Congress to both fully fund the authorized level of $16 billion for Title I in Fiscal Year 2003 and provide $500 million for the School Improvement Fund.

IDEA: The Administration has also proposed a $1 billion increase (+ 13.3 percent) for IDEA special education. Again, while NEA applauds this proposal as a good starting point, we believe it falls short of what is needed. In fact, the proposed budget would provide only 18 percent of the Average Per Pupil Expenditure, less than half of the 40 percent full funding share.

Providing a quality education for all students, including those with disabilities, requires a Federal-State-local partnership. Today, however, Federal IDEA appropriations fall far short of the Federal Government's commitment. As a result, States and localities simply cannot provide students with disabilities the quality of service they need, and often must cut other critical programs or raise taxes in order to provide mandated services. The Department of Education in its fiscal year 2003 Justifications of Appropriations Estimates notes, "Historically, local educational agencies have struggled with meeting the minimal education needs of children with disabilities." In the Fiscal Year 2002 alone, the unpaid Federal contribution shortchanged local schools by $10.5 billion funds that could have made a real difference in modernizing school facilities, training teachers, upgrading technology, or improving curricula.

At the rate of increase under the Administration's proposal, it will take 33 years to reach full funding of IDEA. In contrast, the bipartisan Harkin–Hagel proposal included in the Senate version of the ESEA reauthorization bill last year would phase in full IDEA funding over six years. The Harkin–Hagel plan would also move IDEA to the mandatory spending side, thereby removing it from the arbitrary and unpredictable annual appropriations process, and freeing up discretionary funds for other priorities. Students with disabilities and their families deserve more than an empty promise. Therefore, NEA urges Congress to provide a Fiscal Year 2003 increase of $2.45 billion for IDEA, and to guarantee similar increases for each of the next six years.

Teacher Quality. Research clearly demonstrates that the presence of a highly qualified teacher in a classroom is the most critical element in raising student achievement. The new ESEA law creates new requirements mandating that all teachers be highly qualified within four years. At the same time, States are facing teacher shortages caused by record enrollments and the projected retirements of thousands of veteran teachers. According to the Department of Education, 22 percent of all new teachers leave teaching in their first three years of service, 12 percent of teachers in high-poverty secondary schools hold emergency certification, and 18 percent of teachers are teaching out of their field of expertise. In addition, estimates for the number of new teachers needed range from 2.2 to 2.7 million by 2009.

The combination of new teacher quality requirements and teacher shortages necessitates an increased investment in teacher recruitment and professional development programs.

Although the President in his State of the Union speech recognized the need to recruit more highly qualified teachers in the coming years, the Administration's fiscal year 2003 budget freezes funding for Teacher Quality and eliminates funding for the National Board for Professional Teaching Standards and Teacher Technology Training. Clearly, this proposal is at odds with the goal of improving teacher quality and ensuring every student a highly qualified teacher.

NEA recommends an increase of $1 billion for Title II Teacher Quality for a total of $4 billion. The Math–Science Partnership program should be funded at its authorized level of $450 million. We also strongly recommend retaining funding for the National Board. In addition, we recommend restoring funding for Preparing Tomorrow's Teachers For Technology to the fiscal year 2001 level of $125 million and providing $300 million for Higher Education Act Teacher Quality Enhancement Grants to improve teacher preparation programs.

School Modernization: Another critical component in raising student achievement is ensuring every student a safe, modern learning environment. America would not expect corporate executives and employees to work in overcrowded buildings with leaky roofs, crumbling ceilings, and faulty heating systems. Yet, these unacceptable conditions exist in far too many of the schools educating tomorrow's workforce.

The research on this issue is clear overcrowded classrooms and structurally unfit school buildings impair student achievement, diminish student discipline, and compromise student safety. In contrast, safe, modern, well-equipped schools send a message to our children that we as a nation are willing to invest in their future.

The need for Federal school modernization assistance is also well documented. The National Center for Education Statistics has projected an unmet need of $127 billion just for repairs to existing facilities. NEA's own recent study estimated a $268 billion cost for school repair and modernization. In addition, the Treasury Department's own General Explanations of the Administration's Fiscal Year 2003 Revenue Proposals stated, "Aging school buildings and new educational technologies create a need to renovate older school buildings * * * Many school systems have insufficient fiscal capacity to finance needed renovation * * *"

Yet, despite this documented need, the fiscal year 2002 education appropriations bill eliminated the $1.2 billion urgent school repair program, and the Administration's fiscal year 2003 budget provides no funding for school repair and renovation. The budget does include a two-year extension of Qualified Zone Academy Bonds (QZAB), which have been used successfully by schools across the country. While expansion of QZABs is a good first step, we support the proposal by Senators Harkin and Kerry to create $25 billion of zero-interest bonds, at a five-year cost of only $1.75 billion. A similar proposal offered by Representatives Rangel and Johnson in the House currently has 225 cosponsors a bipartisan majority.

We urge Congress to provide $1.75 billion over five years to subsidize the interest on school modernization bonds, and to provide a $1 billion appropriation for urgent school repairs.

Educator Tax Benefits: NEA supports the Administration's proposal to provide an above the-line tax deduction to offset educators out-of-pocket classroom supply and professional development expenses. Senators Collins, Warner, and Landrieu have also proposed such a tax deduction, and a similar proposal passed the Senate last year by a 98–2 vote.

A 1996 NEA study found that the average K–12 educator spent over $400 a year on classroom supplies. For educators earning modest salaries, such purchases represent considerable expense. Therefore, NEA urges Congress to include the Administration's educator tax deduction in the fiscal year 2003 Budget Resolution. However, we urge making it effective with the 2002 tax year, as opposed to delaying it to 2004 as in the budget request.

NEA also supports increased investments for rural education, higher education, early childhood education, and other critical programs. Our recommendations are detailed in the attached appendix.

Opposition to Tuition Tax Credits

NEA strongly opposes the Administration's proposed taxpayer-subsidized tuition tax breaks for private and religious school expenses. The proposal is essentially a voucher providing direct Federal funds to parents for private and religious school tuition. Similar proposals were resoundingly rejected by strong bipartisan margins during consideration of ESEA reauthorization.

The tuition tax credit proposal will siphon off $3.7 billion over five years from public schools. In fact, the plan would provide more than 2.5 times as much money per child to attend private and religious schools than is currently provided per child to improve achievement of low-income public school students. This funding could be better spent to help the 90 percent of students attending public schools. For example, $3.7 billion could pay for:

Math and reading help for an additional 3.7 million low-income children;

Interest to subsidize $25 billion of zero-interest school construction bonds, plus an additional $2 billion in grants for urgent school repairs for high-poverty schools, or

Salaries of 20,000 highly qualified teachers to reduce class size for the next five years.

The Administration's proposal would also undermine important accountability measures put in place under the new ESEA law. Funds could subsidize private, religious, and home schools that are not held to the same teacher quality and student achievement standards as public schools. Federal funds could also be used to subsidize discrimination, as private, religious, and home schools are not all fully covered by civil rights laws.

Therefore, NEA urges Congress to reject these dangerous voucher proposals and instead to focus on real reform that helps all students succeed.

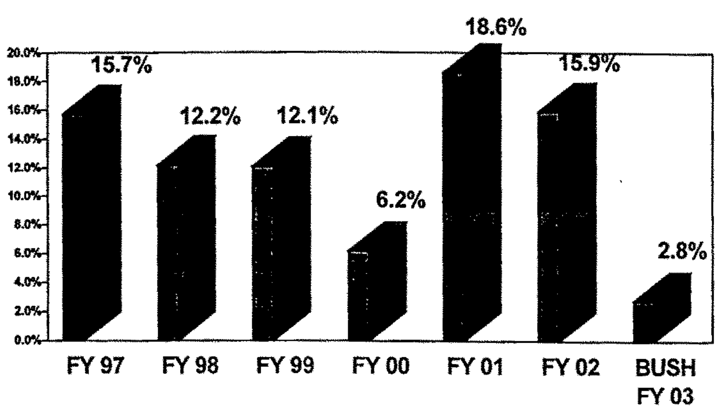
Thank you.

ADDITONAL CHARTS SUBMITTED AT THE HEARING

Appendix B:

Budget Charts

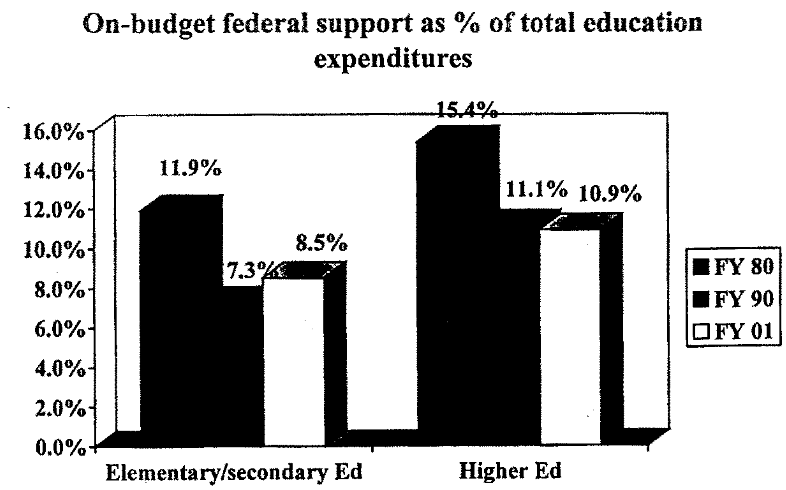
YEARLY PERCENTAGE INCREASE IN DISCRETIONARY EDUCATION FUNDING



1

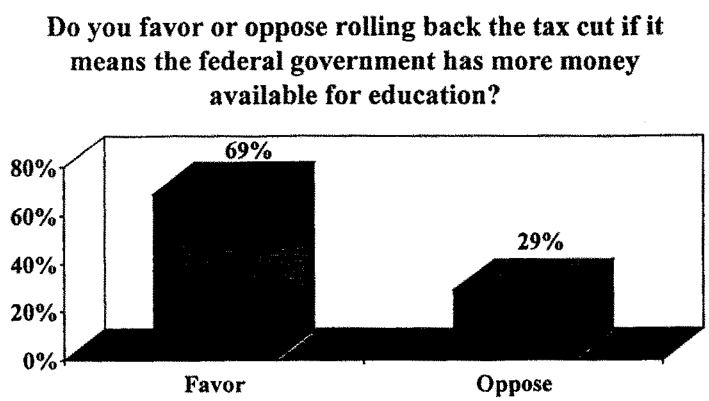
Source: NEA based on Education Department data

FEDERAL SHARE OF EDUCATION FUNDING HAS DECLINED



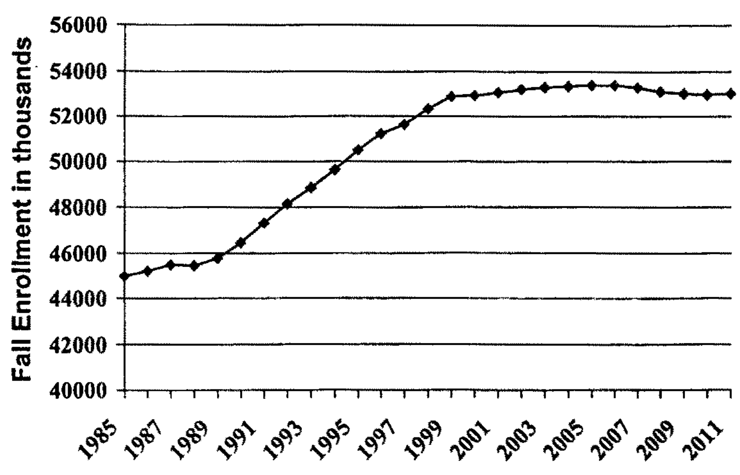
Source: U.S. Department of Education, *Federal Support for Education, Fiscal Years 1980 to 2001*

THE PUBLIC SUPPORTS EDUCATION FUNDING OVER TAX CUTS



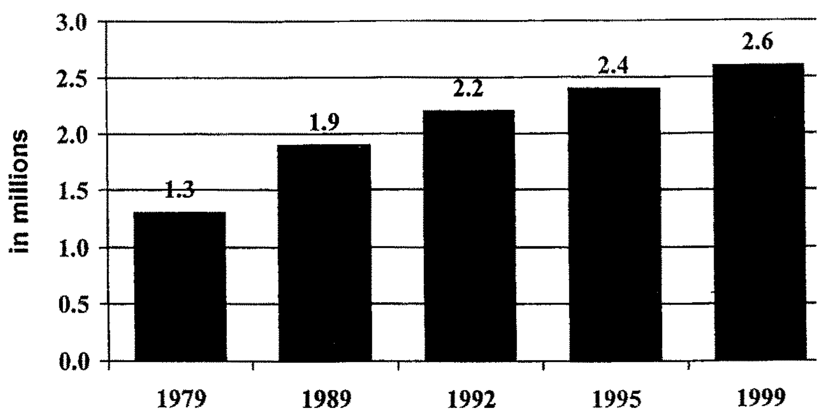
Source: Zogby poll, released 2/14

K-12 ENROLLMENTS AT RECORD LEVELS



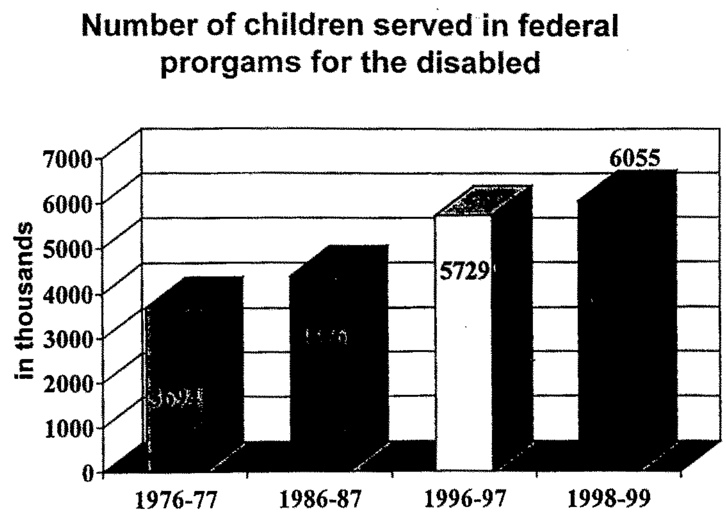
Source: U.S. Department of Education; *Projections of Education Statistics to 2011*
(2010 and 2011 are projections)

MORE CHILDREN HAVE DIFFICULTY SPEAKING ENGLISH



Source: *America 's Children: Key National Indicators of Well-Being, 2001*

MORE STUDENTS WITH DISABILITIES



Source: U.S. Department of Education; *Digest of Education Statistics, 2000*

Chairman CONRAD. Thank you. We appreciate that testimony very much and all the effort that went into it.

Mr. King, welcome.

Statement of Larry King, Secretary, American Association of State Highway and Transportation Officials

Mr. KING. Thank you, Mr. Chairman, and good morning. I am Larry King. I am deputy secretary for the Pennsylvania Department of Transportation, and I also serve as secretary of the American Association of State Highway and Transportation Officials, AASHTO. Thank you again for the opportunity to be here this morning to add to the very useful discussion that has already taken place on highway spending levels for the upcoming fiscal year.

Mr. Chairman, also thank you for your affirming statements on the importance of a strong highway program to safety and mobility in the economy. We appreciate that. We believe much good has been accomplished over the years from this very successful Federal–State partnership, and certainly believe that it is worth keeping at a very strong level.

Mr. Chairman, frankly we in the States are stunned by the fiscal year 2003 budget proposal to slash this $8.6 billion from current highway funding levels. This, in the midst of a recovery from recession, would cut the Federal aid highway program, as you have so accurately stated, by 27 percent because of an apparent slowdown in revenues to the Highway Trust Fund, invoking this revenue-aligned budget authority provision, RABA.

Now, losses of this magnitude, Mr. Chairman, could wipe out much of what we have collectively accomplished over the past 4 years to reduce the enormous backlog of needed highway improvements. It would return us indeed to levels of the decade of the 1990s, as you can see from the chart to my right.

Now, AASHTO has recently completed a survey of its member departments on the impacts on State transportation programs that would occur if this reduction would indeed take place.

Now, it is not just the $8.6 billion in Federal cuts that would be impacted, but also the matching funds that go with those Federal funds, and the damage, therefore, would actually exceed significantly the $8.6 billion Federal cut. But, more importantly, it will delay important projects at the State level. It will impact projects at the city level, county level, and transit agencies also, and would reduce, we fear, the prospects for future transportation funding next year when TEA–21 is up for reauthorization.

Let me cite just a couple of examples from the State survey.

First, in my State of Pennsylvania, this year, 2002, we expect a record-breaking year in highway and bridge construction contracting, more than $1.5 billion worth of work in Pennsylvania this year. However, beyond 2002, in the face of a proposed reduction in Federal funding of $346 million, we in Pennsylvania would be forced to delay up to $500 million worth of contract construction lettings and also an additional impact of $100 million in design costs, right-of-way acquisition, utility relocation, and other pre-construction activities.

In North Dakota, the survey says that the proposed $44 million reduction in Federal funding would trigger some $54 million in program cuts in your home State of North Dakota, increasing the backlog of needed projects and enlarging the gap, which all of us have, between affordable program levels and what is needed, increasing that gap by about 50 percent.

Importantly, also, for North Dakota and for many other States, a reduction of this magnitude would also limit our ability to supplement the high-priority project funding that was specified in the original TEA–21 legislation.

Another example, South Carolina, a reduction of $112 million in Federal funding would have a $140 million impact on their program, and on and on.

We have provided to the committee copies of our survey report, hot off the press, which identifies the direct impact of this proposed funding reduction on each State's transportation program.

In the longer term, we are very concerned that the proposed fiscal year 2003 cut from $32 billion down to $23 billion will be used as a baseline for reauthorization of TEA–21, making it extremely, extremely difficult to enact legislation to address the Nation's highway investment needs.

We strongly support the bill introduced by Senator Jim Jeffords to restore highway funding to not less than $27.7 billion for fiscal year 2003. We commend the Senator and the 27 co-sponsors of the bill for their appreciation of how important sustained highway investment is to our country.

However, we would ask that you look once step farther. It is our emphatic view, and that of the Nation's Governors, that it is vital to sustain Federal highway investment in fiscal year 2003 at no less than the $31.8 billion level provided in fiscal year 2002. With upwards of 40 State Governors and legislatures already contending with severe budget shortfalls and the Nation struggling to recover from recession, it makes no sense, no sense, as you have said, Mr. Chairman, to cut the highway program.

Now, there has been some concern expressed that the Highway Trust Fund can't support full funding at the $31.8 billion level in fiscal year 2003. We believe that this question needs and deserves a credible answer. Therefore, we would respectfully suggest and urge that the Budget Committee obtain calculations from the Congressional Budget Office to determine the maximum sustainable level for highway funding in fiscal year 2003. With that information in hand, it seems to us, as you draft the fiscal year 2003 budget resolution, you could make room to permit the maximum level of Federal highway spending that can be sustained.

Now, as Congress looks to the reauthorization of Federal highway and transit programs next year, this RABA forecasting method we believe needs some refinement to avoid such wild and harmful funding swings in the future, and particularly in times of economic downturn. But clearly, at least to us, the firewall and guaranteed spending principle must be preserved. After all, the intent of the RABA provision is simply to ensure that the revenue collected in highway user fees from all of us is fully spent on transportation improvements. We believe that preserving a mechanism to enable year-to-year adjustments is critically important.

Mr. Chairman, in the final analysis, though, this issue is more than calculations and revenue projections and bricks and mortar. As has been so aptly stated before, it is about people; it is about jobs; it is about people's lives, their safety and their mobility; and it is about economic growth and vitality. Construction contractors throughout the Nation will soon begin to cut back on equipment purchases and lay off tens of thousands of well-paid construction workers. Likewise, engineering consulting firms will almost immediately have to start laying off engineers and technicians, as design work for anticipated projects for next year is delayed or cancelled.

We understand, Mr. Chairman, that there are multiple national priorities competing for limited budget resources, but would submit that investment in better infrastructure makes for a better America.

Thank you, Mr. Chairman.

[The prepared statement of Mr. King follows:]

THE PREPARED STATEMENT OF LARRY M. KING, DEPUTY SECRETARY FOR PLANNING PENNSYLVANIA DEPARTMENT OF TRANSPORTATION

Mr. Chairman and Members of the Committee, my name is Larry King. I am the Deputy Secretary of the Pennsylvania Department of Transportation, and I serve as Secretary/Treasurer to the Board of Directors of the American Association of State Highway and Transportation Officials (AASHTO), and I lead AASHTO's Financial Issues Work Team for Reauthorization. I also am here today to testify on behalf of AASHTO.

I want to thank you for your leadership in scheduling a hearing to specifically address the impacts of the President's proposed Fiscal Year 2003 budget on the Nation's highway infrastructure. I am also honored that you invited me to testify before your Committee. I believe that I can offer a real world picture of the significance of the Federal-aid highway program to the States highway infrastructure programs.

Mr. Chairman, I would like to start by giving your colleagues a brief picture of the Commonwealth of Pennsylvania. Although the Keystone State is not large in geographic size, we are fifth in population with more than 12 million people. One-third of our population lives in rural areas, giving us the largest non-urban population in the country. By 2025 our population is expected to grow by 20 percent to 14.3 million, and most significantly, the number of residents aged 65 and older is expected to grow by 80 percent during the same time period. Pennsylvania also ranks fifth among the States in the size of the highway system under its jurisdiction. The Commonwealth owns, maintains and operates 40,500 miles of highways 34 percent of the total system and 25,000 bridges, which are spread out across many rural miles as well as in the metro areas. This 34 percent percent of the system carries 76 percent of the total vehicle miles of travel. The remaining travel is on systems maintained by municipalities or other governmental agencies.

Pennsylvania also serves as a highway freight land-bridge for the Northeastern States, carrying a higher percentage of trucks on its interstates roughly 35 percent than any other northeastern State. Pennsylvania is called the Keystone State for a good reason. It is the connection between New York, New Jersey, New England and the rest of the country. With more cars, trucks, and increasing vehicle miles of travel, we must focus on preservation of our highways and bridges. At the same time, our highest priority will continue to be ensuring the safety and security of the transportation system while preserving and enhancing the environment. The unique demographics of our State present challenges in developing, maintaining and operating a multi-modal transportation infrastructure that balances the diverse needs across the State increasing congestion in growing urban areas, access and economic development in rural regions, and an aging population with special needs.

To address these challenges, we are working with our local officials and the private sector to try to keep pace with the competing demands on our transportation infrastructure. We have been able to make progress in our safety and highway and bridge preservation and capacity needs across all regions of the State. For example, in just one year beginning in 2000, we reduced the number of closed bridges by 29 percent while the number of miles of Interstate highways with poor pavements declined by 26 percent and the number of miles of National Highway System road with poor pavements declined by 41 percent. This progress would not have been possible without the 40 percent growth in the Federal aid highway and transit programs provided by the Transportation Equity Act for the 21st Century enacted in 1998. The additional resources from TEA–21 have enabled us to leverage our State and local resources to complete such projects as:

United States 22/322, Dauphin Bypass, Dauphin County, $85.4 million, a crucial four-lane limited access connection north of the State capital at Harrisburg.

United States 11/15, widening, Perry County, $58.8 million, another important connection north out of Harrisburg to the Williamsport area.

Kittanning Bypass, Armstrong County, $39 million, and United States 6, Tunhannock Bypass west, nearly $21 million—two projects which stood in line for decades awaiting funding. Both are taking heavy truck traffic off the Main Street of two towns, making them much more livable.

Mr. Chairman and Members of the Committee, we in the States are stunned by the fiscal year 2003 budget proposal which, in the midst of trying to climb our way of a recession, would cut the Federal aid highway program by $8.6 billion. While we recognize this reduction is the product of an apparent reduction in estimated revenues to the Highway Trust Fund, which triggered a reduction in the calculation of Revenue Aligned Budgetary Authority (RABA), the results are not mechanical. This reduction would mean a disastrous cutback in highway improvements, reducing our ability to meet basic highway needs, and the loss of thousands of jobs.

We support S. 1917, the Highway Funding Restoration Act recently introduced by Senate Environment and Public Works Committee Chairman James Jeffords, which would restore highway assistance to no less that the $27.7 billion level for fiscal year 2003 authorized in TEA–21. We believe that this is a good first step.

However, we want to share with you our emphatic view that it is vital to sustain Federal highway investment in fiscal year 2003, at no less than the $31.8 billion level provided in fiscal year 2002. With 37 State governors and legislatures already contending with severe budget shortfalls, with revenue projections down in 45 States, and the Nation in an economic downturn, cutting the highway program by

$8.6 billion just makes no sense. This is especially so when there are more than sufficient reserves in the Highway Trust Fund to provide funding for fiscal year 2003.

Let me outline what we believe the consequences would be unless current levels of funding are sustained.

As early as next month, State and local officials will begin the task of cutting billions of dollars in highway projects from their fiscal year 2003 Transportation Improvement Programs. Final decisions will be made public in September affecting nearly every community in the Nation.

Construction contractors throughout the country will start making business plans on how to cut back their equipment purchases and lay off tens of thousands of well-paid construction workers. The stock prices of several heavy equipment manufacturers and construction companies have already dropped. Engineering consulting firms, already hard hit by the recession, will almost immediately have to start laying off engineers and technicians as design work for next year's projects is delayed or canceled.

Numerous projects will be delayed in every State. These are projects that the public has long awaited and expect to be completed as promised.

This cut is proposed at a time when we continue to have increased needs for highway safety and preservation projects, and for new capacity projects in the more rapidly growing western, southwestern and southeastern regions of the country. In addition, since the tragic events of September 11th the capital and operating needs associated with hardened transportation facilities and dealing with emergency response, including communication infrastructure needs, are greater than ever.

At the same time, traffic volumes are up all over the country. The most recent data from the Federal Highway Administration shows an increase in annual traffic growth of nearly 3 percent.

State Impacts

AASHTO recently completed a survey of State departments of transportation to assess the direct and indirect dollar and project impacts across all 50 States. I have attached a copy of the results of that survey, but want to share some of the highlights of the consequences of a $8.6 billion cut in the Federal aid highway program:

The reduction will result in substantial project delays and in creased costs, even if Federal funding is eventually restored. In *North Dakota*, the reduction would increase the size of the existing backlog of needed projects, and increase the gap between the program and program needs by about 50 percent. In *Iowa*, this result would be a delay of approximately $50 to $60 million in State highway/bridge construction projects in fiscal year 2003. Cities and counties would be forced to delay approximately $25 to $30 million in local road and bridge projects. *South Carolina* would be forced to delay $25 million in pavement and reconstruction contracts, $22 million in Interstate upgrades, $35 million in Interstate maintenance, $15 million in Safety upgrades, $11 million in Bridget Replacement, and a total of $31 million in other areas including Enhancements, Planning, and Advance Construction for fiscal year 2003. *Texas* reports that the long term effects of their anticipated $532 million reduction include significant project scheduling impacts with less funding available in fiscal year 2003 to acquire right-of-way and fund preliminary engineering. *In Oklahoma* a total of $120 million in construction and right-of-way projects would be delayed or cancelled.

The reduction in Federal funding will put a great strain on State resources during a time when the economy is and State tax revenues are declining. *Washington State* reported that it is in the midst of a transportation funding crisis and the $125 million reduction could not come at a worse time. *Wisconsin* is facing a $1.1 billion general fund deficit. While the State's transportation fund is currently in balance, it has been used to help offset the general fund deficit. Current proposals include transfers of $25 million or more from the transportation fund, $5 million of which has already been transferred. The combination of the Federal funding reduction, State budget overestimate, and State transportation fund transfer for the general fund deficit could reduce transportation funding in the State by $175 million or more.

The reduction in Federal funding would result in unacceptable job losses. Estimates show that an $8.6 billion reduction could result in over 150,000 jobs lost in the peak year. In *Montana* the reduction would mean a loss of 2,805 jobs—roughly equal to 25 percent of the new jobs created in Montana in 2001.

The reduction would result in less funding for local projects and transit. For fiscal year 2003 *New Jersey* plans to transfer two-thirds of its Congestion Mitigation and Air Quality (CMAQ) funding ($65 million out of $97 million) to transit. These funds would have to be proportionally constrained. *Nebraska* would have to delay approximately $45 million of State Highway System projects and about $15 million of Local System projects in fiscal year 2003.

Mr. Chairman, these are but a few examples of the very real consequences of the cut in Federal aid highway funding resulting from the most recent RABA calculation. The mechanism itself was created as a tool to ensure that the highway user revenues going into the Highway Trust Fund would be fully used for the Federal aid highway and transit programs. Like any new mechanism a new car design, the latest office technology or kitchen gadget—sometimes defects and imperfections show up and must be fixed. We believe that Congress could not have foreseen and certainly never intended such an abrupt cutback in the highway program and its resulting devastating job losses at precisely the time of an economic downturn.

Mr. Chairman, we respectfully recommend that given the current economic conditions, the negative impacts to States, and the documented need for infrastructure investment, the Federal aid highway program be sustained at the fiscal year 2002 level of $31.8 billion. We further suggest that the current $19.3 billion cash balance in the Highway Trust Fund is more than sufficient to cover the $2.4 billion in additional outlays that would be required to sustain current highway program levels in fiscal year 2003.

A Response

The public policy questions Congress needs to address are these. First, to assist in the Nation's economic recovery does it not make sense to sustain highway funding at $3 1.8 billion? Second, are there reserves and cash flow in the Highway Trust Fund to make this possible in fiscal year 2003? We believe that the answers are emphatically "Yes" and "Yes!"

Funds Are Available to Sustain fiscal year 2002 Levels

Four years ago Congress agreed to the fundamental principle that all the receipts going into the Highway Account would be fully used for transportation purposes, and not be used to hide the deficit or offset other government expenditures. But today there is a $19.3 billion cash balance in the Highway Trust Fund. We seek to provide $8.6 billion in obligations to restore the highway funding to the fiscal year 2002 level. The budget impact of this increase will only require $2.4 billion in outlays for fiscal year 2003 this will allow us to continue the momentum we have achieved in fiscal year 2002.

The table displayed below shows receipts and expenditures for the Highway Account of the Highway Trust Fund for Fiscal Year 1998 thorough Fiscal Year 2003. Even accounting for unpaid obligations, it is clear that there is a substantial balance in the Highway Account with receipts exceeding outlays over the six-year period. Mr. Chairman, we respectfully urge the Congress and the Administration to honor their commitment to spend all the receipts going into the Trust Fund, unlock the balances that have built up and make a positive contribution to the current economic recession.

We recommend that the Budget Committee take two immediate steps in support of reaffirming Congress commitment to the principle of spending all receipts to the Trust Fund. First, we urge you to request that the Congressional Budget Office develop independent estimates of the level of highway funding that the Highway Trust Fund can sustain while maintaining a sufficient balance to avoid a cash deficit. Second, as you craft your budget resolution for Fiscal Year 2003, we urge you to include sufficient funding to maintain highway funding at the fiscal year 2002 level.

Highway Account Receipts and Outlays

Fiscal year	Receipts	Outlays	Difference
1998	24.3	20.3	4.0
1999	33.8	23.1	10.7
2000	30.3	27.0	3.3
2001	26.9	29.1	-2.2
*2002	27.7	30.2	-2.5
*2003	28.6	30.6	-2.0
Subtotal	**171.6**	**160.3**	**11.3**
Balance from ISTEA	8.0		
Total	**179.6**	**160.3**	**19.3**

Estimated

Note: The Highway account balance was $8 billion at the beginning of TEA-21. Therefore, the cash balance at the close of FY 2001 is $20.3 billion.

Source: Federal Highway Administration.

FIREWALLS AND REVENUE ALIGNED BUDGET AUTHORITY

As we look to reauthorization of TEA–21 and the future of the Federal-aid highway program, we believe that it is essential to preserve and reaffirm the principle of a user-based transportation financing system in which all receipts are guaranteed to be used for the purposes for which they were intended.

To accomplish this, TEA–21 set highway obligations at levels based on then-current estimates of gasoline and related tax receipts, and established two mechanisms to guarantee spending. First, separate budgetary spending caps or "firewalls" were established in the Budget Enforcement Act for highway and transit spending. Second, TEA–21 included an adjustment mechanism, Revenue Aligned Budget Authority (RABA), to annually adjust the spending caps or "firewalls" based on updated revenue estimates, increasing or decreasing highway spending each year so that it would align itself with Highway Trust Fund receipts.

These tools RABA and the "firewall" provisions—were designed to provide the long-term fiscal stability needed for State and local highway and transit agencies to finance, design and execute multi-year multi-million dollar construction programs.

Mr. Chairman, we urge you and the Members of your Committee to maintain the "firewall" provision for highway and transit spending.

REFINEMENT OF THE RABA MECHANISM

Recent experience has demonstrated that there are unintended flaws in the RABA mechanism. Changes in economic conditions that result in minor adjustments to estimated receipts cause wide swings in highway funding levels. As with any new mechanism, it is appropriate that we carefully examine and refine the RABA mechanism, including its calculation methods and revenue estimating procedures. We recommend that Congress consider replacing the current calculation method with one that simply compares actual previous year receipts to the assumptions made at the time the bill passed, with the difference becoming the RABA adjustment.

ACCURACY OF THE RABA CALCULATION

One serious concern that must be addressed is the accuracy of the process used by the Department of the Treasury to determine the revenue estimates used in calculating RABA. The correction of a $600 million error by the Department of Treasury has already reduced the proposed highway cutback to $8.6 billion. Recent information on fiscal year 2001 truck sales and fuel tax revenues at the State level call into question the Treasury forecasts. For example, the American Trucking Associations indicates that its data shows truck sales down by 23 percent for 1991 as compared to the Treasury estimate of 50 percent. This leads us to believe that other adjustments in RABA could occur.

We recommend that you consider instituting reforms to the Department of Treasury's process for estimating tax receipts to the Highway Account. This is not the first time that the Department of Treasury has made costly errors. In 1994, a $1.3 billion error eventually cost $3.6 billion to correct. This most recent $600 million error leaves us with absolutely no confidence in their accounting methods. We are not alone in our concerns. In June 2000, the United States General Accounting Office released a report in which they indicated that "Treasury's process for allocating tax receipts to the Highway Account of the Highway Trust Fund is complex and error prone." At the request of House Transportation and Infrastructure Chairman Don Young and Ranking Member James Oberstar, GAO is now engaged in a new review of Treasury's methods for estimating receipts to the Highway Account. We urge you carefully consider the results of GAO's review, and consider appropriate reforms during reauthorization.

LONG-TERM ISSUES

In addition to the immediate impacts of reducing highway spending by more than a quarter, the RABA downward adjustment has longer-term consequences for the Federal-aid highway program. If the obligation level for Fiscal Year 2003 is adjusted downward from $31.7 to $23.2 billion, then the $23 billion level will become the baseline for reauthorization of TEA–21. That would leave us at a starting point $8.6 billion below where we are today, and considerably lower that the $27.8 billion obligation level for fiscal year 2003 contained in TEA–2l. Starting in such a deep hole, would make it much more difficult to maintain the Federal-aid highway program at current levels, and perhaps impossible to expand it.

CONCLUSIONS

In conclusion, I would like to State that the Federal-aid highway program has been one of the most successful Federal-State partnerships ever created. It has contributed to the Nation's mobility safety, and to the unprecedented economic growth that the nation has experienced since the 1950's.

TEA–21 is a major step forward in providing much-needed funding to the Nation's highway and transit program, It is essential that the RABA principle of fully spending Highway Trust Fund receipts and guaranteeing that spending be maintained. However, it is also essential that in a time of recession, the consequences of the RABA mechanism not be permitted to eliminate hundreds of thousands of jobs while setting back much-needed transportation projects nationwide.

We emphatically believe that there are sufficient receipts in the Highway Trust Fund to sustain a higher program level. Authorizing a higher level is consistent with TEA–21, which provided additional contract authority to the States to assure that the Congress could elect to increase the program above the guarantee. We urge the Congress to make this investment in America. We urge the Congress to deliver on the promise of TEA–21 to fully use all the revenues in the Highway Trust Fund.

Chairman CONRAD. Thank you.

Might I just inquire, Mr. King, have you looked at this question of job loss associated with the cut that has been proposed in the President's budget?

Mr. KING. Yes, we have, Mr. Chairman. There are several algorithms around for estimating job impacts. Administrator Peters earlier referred to a 38,000-job-per-billion impact. There are higher estimates around. I have seen 42,000 also as an estimate. But, clearly, the job impact potential here is enormous, and the 350,000-job impact number that you used we believe is in the ball park, certainly.

Chairman CONRAD. So you believe that that estimate has credibility? That is an estimate that was given to me in a hearing that we conducted in North Dakota during the break on the question of the impact of the President's proposal, not only in terms of projects underway but what the impact would be on jobs. And the number that we were given was actually in excess of 350,000. So you think that would be in the ball park?

Mr. KING. Yes. And to be clear, the job impact estimates not only include people who are actually working in the projects themselves, but also people working in the supply industries and other attendant industries that support—

Chairman CONRAD. Engineering firms?

Mr. KING. Absolutely.

Chairman CONRAD. Yes. We understand that. I thought what Ms. Peters said here was not credible. She talked about 18,000 jobs lost. That I don't think has any serious credibility attached to it as a number. Did you hear her testimony with respect to that?

Mr. KING. I certainly did, yes, and frankly I didn't follow the logic of that particular number.

Chairman CONRAD. I don't think there is any logic to it. It is kind of make-believe.

Let me ask you this: I don't know if we are going to be able to fully restore this cut, $8.6 billion. That is a very serious problem. We know we can't live with the magnitude of the cut the President has proposed. It would not be good for the economy given the attendant job losses. It would not be good for the overall efficiency of the economy given the cost of gridlock that is occurring all across America.

I know that AASHTO and the Governors are asking us to fully restore the cut. Have there been any other calculations done by your organization with respect to other levels of funding that you would consider?

Mr. KING. Well, certainly, Mr. Chairman, we would always want the maximum level of funding, to state the obvious. We believe, again, that the crux of this question lies with the level of funding that can be supported by the Highway Trust Fund. And as we know, there are a number of different versions of what that number might be.

Chairman CONRAD. Yes, that is correct, and there is a very important point that you made in your testimony, and I want to tell you that we will absolutely follow the request that you have made to ask the Congressional Budget Office to do a calculation of what will the trust fund sustain.

I am sorry to have interrupted.

Mr. KING. That is quite all right, Mr. Chairman. Beyond that, though, the GAO is presently examining the numbers that have been forthcoming from the Treasury Department relative to the Highway Trust Fund revenue picture. You may recall that when all of this began a few months ago, the anticipated cut was $9.2 billion. Then suddenly there was a $600 million error in the revenue statistics that was discovered, which now results in the $8.6 billion number.

Frankly, that leaves us little confidence in the Treasury Department's numbers, and there is an ongoing study right now by GAO looking at the process, if you will, for generating those numbers by the Treasury Department.

Chairman CONRAD. Let me just ask a final question here. I have been told by some that an informal calculation has concluded that if we were to have the entire $8.6 billion restored, it would then require a gas tax increase for TEA–21 authorization to stay even. Are you familiar with assessments that have reached that conclusion?

Mr. KING. I am not, Mr. Chairman. As a matter of fact, I seem to recall that there are some assessments, again, perhaps informal, that would show that the existing tax structure can support a program level in the range that we are speaking of here for the foreseeable future.

Chairman CONRAD. Well, that is obviously the question we have got to get answered here. We do not want to trigger any requirement for a gas tax increase. That is not the purpose of this undertaking. So it is very important that we get what, in fact, the trust fund will sustain. I thank you very much for your testimony.

Mr. KING. Thank you, Mr. Chairman.

Chairman CONRAD. Mr. Till, welcome. Thank you very much for being here, and thank you for your patience as well. I appreciate that. If you would proceed?

STATEMENT OF THOMAS A. TILL, EXECUTIVE DIRECTOR, AMTRAK REFORM COUNCIL

Mr. TILL. Good morning. Thank you very much, Mr. Chairman. I am just happy to have an invitation to present the council's views today, on the President's budget and its effect on funding infrastructure investments and other expenses related to intercity rail passenger service.

Also here today, Mr. Chairman, is one of the council's members, Mr. James Coston of Chicago.

I am going to speak to the council's views in the context of the council's Action Plan for Restructuring and Rationalization of the National Intercity Rail Passenger System, a report that was submitted to the Congress on February the 7th, and with your permission, Mr. Chairman, I will summarize my statement and submit the full statement for the record.

Chairman CONRAD. I appreciate that very much, Mr. Till.

Mr. TILL. The council has submitted its recommendations to the Congress for reform, and we are sure that other reasonable reforms will be proposed for Amtrak. Indeed, Senator McCain has introduced I think an 86-page piece of legislation with that objective in mind.

I think the most important thing is that the council believes that reform of Amtrak is no longer an option, Mr. Chairman. Reform is an imperative. It is an imperative both for effective operation of the passenger program and passenger service, and it is also an imperative, as I hope you will conclude after my testimony, if we are to fund rail passenger service effectively.

Over its lifetime, Amtrak's ridership growth has barely kept pace with the growth of the United States population. And contrary to popular belief, the period between September 11th of last year and the end of last year, in that period Amtrak carried fewer passengers than it did in the comparable period of the year before, 2000. Amtrak is burdened with debt and debt service, and its assets are in poor condition. And the continuing deterioration of Amtrak's performance since the council was established led the council to its finding last November that Amtrak would not be operationally self-sufficient by December 2, 2002, as the Amtrak Reform and Accountability Act of 1997 requires.

Indeed, Amtrak is no closer to self-sufficient today than it was in 1997, despite the appropriation to Amtrak, over 5 years, of more than $5 billion, including $2.2 billion in capital funding under the Taxpayer Relief Act. Amtrak's announcement on the 1st of February of this year that it needs $1.2 billion for 2003 or it will shutdown the network of 18 long-haul trains is likely to be business as usual for Amtrak: lower revenues than projected, higher costs than projected, greater losses than projected.

Sadly, Amtrak has proven that it cannot in its current structure concentrate on its core mission of running trains. It has too much to do, and it does little of it well. As it is chartered and organized today, no agency of the Government has effective oversight of Amtrak's business plans, its funding requests, or its financial and operational performance. A program cannot be effective without effective oversight, and Amtrak has none.

The action plan the council sent to Congress on the 7th of February thus recommends a fundamental restructuring of the way we organize, fund, and operate rail passenger service under a new program that provides a structure for operating passenger, mail, and express service, and also separately for developing the infrastructure to support those operations throughout the country. If we are to have an effective rail passenger service, Mr. Chairman, the council believes we have to organize and fund passenger trains and the infrastructure that supports them separately.

The council proposes that the new program be administered by a small Federal agency, which is a restructured National Railroad Passenger Corporation, an institution which already exists in the current Rail Passenger Service Act. The council recommends that the NRPC be modeled after the United States Railway Association, which was created by Congress in 1973 to restructure Penn Central and six other bankrupt Northeast railroads.

USRA enforced strict accountability on Conrail, it shielded Conrail from political interference, and by working closely with Conrail management, contributed to Conrail's success. The council believes that the national passenger rail program needs and would benefit from a similar oversight organization.

In this framework, a new train operating company could concentrate on running trains, with the resources to do so, under contract, with no unfunded mandates, and without political pressure on its management decisions.

To ensure that there are adequate incentives for efficiency, the council proposed a national passenger train operating company. The council also recommends introducing the possibility of competition into the provision of passenger train services. In many countries around the world, reforms in the provision of both passenger and freight rail service have involved competitive bidding for contracts to provide those public services.

Our recommendations also deal strongly with the parts of the Northeast Corridor and other infrastructure that Amtrak owns. Today Amtrak is a minority user of the Northeast Corridor—running only about 150 of the corridor's 1,200 trains—and its finances and management cannot bear the burden of maintaining and improving what is largely a commuter facility. The main evidence of the infrastructure's physical deterioration is the increase in minutes of delay under Amtrak's stewardship—from 134,000 minutes in 1998 to 234,000 minutes in 2001, or more than 160 days of train delay. The system is literally slowing down, and this is reported in the January 2002 report of the DOT Inspector General.

The council's final major recommendation for a passenger program is that the Congress enact measures to provide stable and adequate sources of funding—separate sources for train operations and for infrastructure—under a restructured rail passenger program. There are those who say that putting more money into the existing Amtrak is all we need to do. The council strongly rejects that notion. What we have today, Mr. Chairman, is an institution that through more than 30 years of existence has never had the full confidence of either the Congress or the Executive regarding its ability to spend money properly. And this is without regard to which party controlled either of those branches. Effective structural reforms will correct that lack of confidence.

Even then, the reality of Government funding today poses important challenges, as you know, to effective funding of passenger rail infrastructure and other needs. Guaranteed spending programs have been very beneficial for highways, transit, and aviation, but other modes of transportation are having a tougher time getting funds appropriated. Today guaranteed spending programs predetermine the appropriation of 75 percent of all transportation funds. As a result, there is no room in the appropriations bill to fund major facilities such as the Northeast Corridor infrastructure, which needs all by itself about $1 billion a year. Clearly, the Northeast Corridor infrastructure has to be shifted to an owner that has better access to Federal, State, and local guaranteed funding than Amtrak has.

Most important for the infrastructure needs of an improved passenger rail program are several bond bills that have been introduced. One is the High Speed Rail Investment Act [S. 250], cosponsored by Senators Daschle and Lott. A bill sponsored by House Transportation and Infrastructure Committee Don Young, so-called RIDE–21 [H.R. 2950], would provide $36 million in tax-exempt bonding authority—and $35 billion additional in loan guarantees—for railroad investments.

Under appropriate safeguards, as another potential source of funding, the council also recommends that States should have the flexibility to use highway and aviation funds for investments to improve the intermodal connectivity of the passenger network or to fund rail investments that would relieve highway or aviation congestion in short-haul corridors.

The Federal fuel tax revenue shortfall of approximately $8 billion, which has been spoken about much here today, is not only bad for highway infrastructure; it will have a devastating impact on the flexible provisions of TEA–21.

Pending House and Senate bills would restore funding above the Administration's request. If the funding is restored, the likelihood that the flexibility provisions will be exercised is greater because the highway program would be funded to the level projected in TEA–21.

When such a program—and I am talking about a rail infrastructure program—is enacted—and I say "when," not "if"—such funds will be the engine for an effective Federal–State rail infrastructure program, in cooperation with the freight railroads, to support improved passenger service. The systematic and continuing improvement of railroad infrastructure that this program would support is the essential foundation for the sound national passenger program that America needs, both across the country as well as in the Northeast Corridor.

The issue of funding for operating subsidies and other capital needs of long-haul trains or of corridor trains is more difficult. The council's action plan recommends the Government provide funding on the basis of a formula that would promote efficient use, not simply fund inefficient, deficit-ridden operations. Funding under such a structure might be provided through appropriations or through some dedicated source of funding. Some have suggested that a new penny might be added to the Federal motor fuel tax that could go to rail uses if matched by a new penny from a State's motor fuel tax. Under the program structure that the council recommends, in which train operations would be provided under contract, much of the funding for passenger equipment investment needs of the operating company, in the council's view, should be able to be secured from private capital markets.

Let me now address the Northeast Corridor infrastructure.

Chairman CONRAD. If I could just interrupt before you do that, I would just say, Mr. Chase and Mr. King, we would be happy to excuse you at this point. We had indicated we would try to be done at noon, and perhaps you have made plans on that basis. So I would want to at this moment excuse the two of you so that we keep our commitment. I thank you both very much for being here.

I apologize, Mr. Till, for interrupting, but we had reached the appointed hour.

Mr. TILL. No need to apologize.

Chairman CONRAD. Because of the vote earlier we have been delayed, and I didn't want them to miss something. Please proceed.

Mr. TILL. Thank you, sir.

Let me address the Northeast Corridor infrastructure. Separating the Northeast Corridor infrastructure—both organizationally and financially—from Amtrak's nationwide train operations—and that includes their train operations in the Northeast Corridor—is another way of narrowing the gap between the subsidy needs of Amtrak's train operations and the uncommitted funds available in the budget. There is little or no chance that Amtrak will be able to get the capital it needs if it is to maintain and improve the Northeast Corridor rail infrastructure out of appropriated funds. It has not been able to do so. Why?

Amtrak has demonstrated that it will try to use whatever capital is available to offset the operating losses of its trains. To fund operations, Amtrak raised $300 million for operating expenses last year by mortgaging 16 years of future income from two concourses in Penn Station, New York. It regularly charges portions of its large management overhead to capital projects, and it has deferred maintenance on the Northeast Corridor infrastructure below levels needed for minimum operational reliability, according to the DOT inspector general. And despite the $3.8 billion backlog of capital projects on the Northeast Corridor, Amtrak did not request the full amount of appropriations authorized by the Congress under the Amtrak Reform Act.

And we were quite surprised, Mr. Chairman, that, in their February 1st press conference; that they indicated that the Congress had not provided that money. The fact is Amtrak did not ask for it.

Our view is that Amtrak, as is presently structured, cannot be an effective public steward for the vital infrastructure known as the Northeast Corridor.

The council's action plan describes a variety of funding sources for the corridor, which, while not directly available to Amtrak, may be much more accessible to State governments to assist in providing the investments to support their large NEC commuter operations.

Indeed, there is no single source, no silver bullet, that could provide all the necessary capital for the Northeast Corridor. Thus, the Congress should look at a variety of sources, which may include:

Bond bills that are pending before the Congress, as I mentioned before;

A Federal appropriation, perhaps through a reauthorized Northeast Corridor improvement program, to address some of the life/safety projects that must be addressed soon, particularly in Penn Station, New York, and several bridges and tunnels;

The Congress might also consider providing part of the funding needed to establish a trust fund to pay off bonds for Northeast Corridor life/safety improvements;

TIFIA and RRIF, railroad loan guarantee and loan programs, may be employed in various ways. One way would be to work with regional transmission organizations in the Northeast, in partnership with a restructured National Railroad Passenger Corporation and the States, to undertake one of the major projects south of New York, which would be the funding of the replacement of the electric traction system, which is keeping Acela Express at a speed or 135 miles an hour, rather than its designed speed of 150, south of New York;

As mentioned above, the Congress should consider expanding the flexibility provisions in current transportation trust funds to include the Northeast Corridor projects that would reduce highway and air traffic congestion;

And—I am sorry General Flowers and Mr. Parker have left—civil works projects under the Army Corps of Engineers are often undertaken with Federal transportation funds, and there is some precedent for the Corps to undertake bridge projects that are over navigable waters. And I am sure that throughout the Amtrak network and certainly in the Northeast Corridor, there are a number of bridges that are in critical condition;

The Congress could also expand the role of the NEC States through special-purpose mechanisms for ownership and control. Assets such as the Penn Station Complex, whose needs have been neglected for decades, might be effectively handled under some kind of appropriate regional umbrella;

And, finally, Federal and/or State tax incentives might be developed to encourage the private sector to make investments in the corridor. The Association of American Railroads has suggested a similar funding mechanism for railroad investments nationwide.

Mr. Chairman, the council believes its recommendations are strong and that they are sound. The chronic difficulty that Amtrak experiences—year in and year out—are not principally due to lack of funding. They spring primarily from an organization that is obsolete and that desperately needs to be redesigned.

Effective reform will beget funding, at least better funding than we have today. Funding alone will not beget reform.

Mr. Chairman, thank you for the opportunity to testify, and I am pleased to answer any questions.

TESTIMONY OF THOMAS A. TILL, EXECUTIVE DIRECTOR, AMTRAK REFORM COUNCIL

Mr. Chairman, members of the committee, thank you for the opportunity to appear before you today to discuss the Council's views on funding for infrastructure and other needs to support intercity rail passenger service.

My name is Tom Till, and I am the Executive Director of the Amtrak Reform Council. I am here together with one member of the Council, James Coston, and several members of the staff, in response to your invitation to present the Council's views on the effect of the President's FY 2003 Budget Proposal on the prospects for financing needed improvements in rail infrastructure to support passenger rail operations. At first glance, it might appear that this has little to do with the other issues before the Budget Committee today, but I can assure you that there is a real link between the funding of road infrastructure and even infrastructure provided by the Corps of Engineers. The views I present today will be consistent with the Council's Action Plan for the Restructuring and Rationalization of the National Intercity Rail Passenger System, which was submitted to the Congress on February 7, 2002. With your permission, Mr. Chairman, I will summarize my statement and submit the full statement for the record.

The Council's Action Plan clearly states the spirit of the Council's recommendations:

"The Council's view is that there should be a bright future for passenger rail service in America. But the Council believes that passenger rail service will never achieve its potential as provided and managed by Amtrak. A new and different program is needed to move forward."

In its three years of operation, the Council found strong and growing support for a modern, improved national program of intercity rail passenger service. The Council's dialogue with the States, Amtrak, and others, together with its own analyses and deliberations, have led us to support major improvements in our national passenger program based on a sound vision.

Amtrak's performance is at odds with this vision. Over its lifetime, the increase in Amtrak's ridership has barely kept pace with the growth rate of the U.S. population. Despite popular belief to the contrary, Amtrak's ridership did not increase between September 11, 2001, and the end of last year compared to the same period in 2000. Amtrak is burdened with debt and debt service, and its assets are in poor condition. And Amtrak's organizational structure and its management and financial systems are not those of a modern corporation.

For these reasons, the Council strongly recommends that the Congress first adopt badly needed institutional reforms before providing major new funding for passenger rail service.

The Council has submitted its recommendations to the Congress. We are sure that other reasonable reforms will be proposed. The most important thing is that reform is no longer an option, Mr. Chairman. Reform is an imperative.

I. The Failure of Today's Amtrak

On November 9, 2001, the Amtrak Reform Council found that Amtrak will not achieve operational self-sufficiency by December 2, 2002, as required by the Amtrak Reform and Accountability Act of 1997. Amtrak finished FY 2001 with a loss of $341 million for purposes of self-sufficiency, as the test is defined by Amtrak, and a record operating loss of $1.1 billion under Generally Accepted Accounting Principles.[1] Amtrak is no closer to self-sufficiency today than it was in 1997, a conclusion recently affirmed by the Inspector General of the US Department of Transportation, and Amtrak's announcement on February 1, 2002, that unless it receives $1.2 billion of Federal funding in FY 2003, it will eliminate all long-haul routes on October 1, 2002. Amtrak's actions to raise needed cash by mortgaging a portion of Penn Station and increasing its debt have weakened the company's financial condition.

Sadly, Amtrak has proven that it cannot concentrate on its core mission of running trains and running them well. Under current law, there is no one who can hold the railroad accountable. It has too much to do, and does little of it well. As it is chartered and organized today, Amtrak does not have any effective oversight of its business plans, its funding requests, or its financial and operational performance. Nor are its many business operations flexible, innovative, or responsive to customer needs. One knowledgeable commentator called Amtrak "a self-regulating monopoly"; it tries to set passenger rail policy, build and maintain the 366 miles that it owns of the 460-mile Northeast Corridor infrastructure[2], raise money, and run some 300 trains a day nationwide both in the Northeast Corridor and over 20,000 miles of private railroad tracks.

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[1] Based on Amtrak's unaudited financial statements. As of February 25, 2002, Amtrak had not released audited financial statements for the fiscal year.

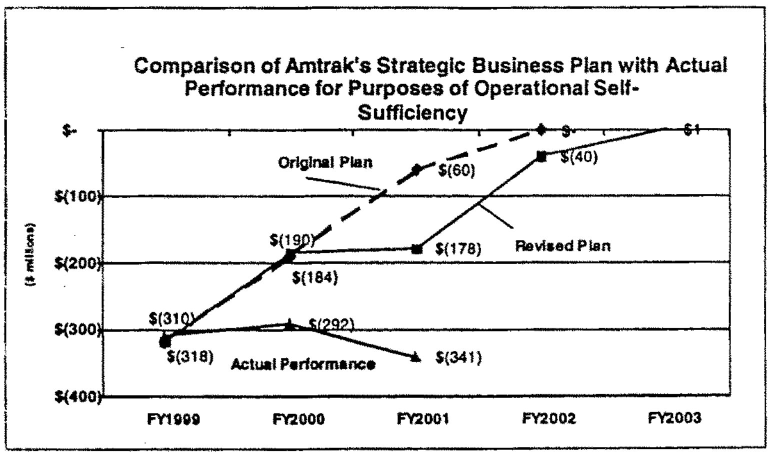
[2] See Appendix for a diagram of the Ownership of the Northeast Corridor Infrastructure.

A. *Problems of a Flawed Institution*

The vision of improved passenger rail operations bears no resemblance to the performance of Amtrak over its 30-year history. The Council previously determined, as reported in its Second Annual Report, that the roots of Amtrak's flaws lie in its institutional structure. While one may criticize the management, the board of directors, and even the employees or the unions, the institutional structure is the root cause of Amtrak's problems. Effective reform will ensure that these same flaws do not undermine a new passenger rail program.

Some outstanding examples of Amtrak's problems under its existing organizational structure include:

- Failure to develop and execute sound business plans has prevented Amtrak from meeting its goals for revenue growth and cost containment.



Amtrak's original Strategic Business Plan for FY1999 FY2002 projected that Amtrak would achieve self-sufficiency in fiscal year 2002. With the delays in the introduction of Acela Express service and rising costs, Amtrak had to revise its Business Plan, pushing back the date for achieving operational self-sufficiency a full year to fiscal year 2003. Amtrak finished fiscal year 2000 $100 million behind its revised Plan. Amtrak finished fiscal year 2001 more than $150 million behind its revised Plan and about $280 million behind its original plan. Its operating loss for purposes of operational self-sufficiency—as that test is defined by Amtrak—increased in FY2001 to $341 million[3], up from $292 million in FY2000.

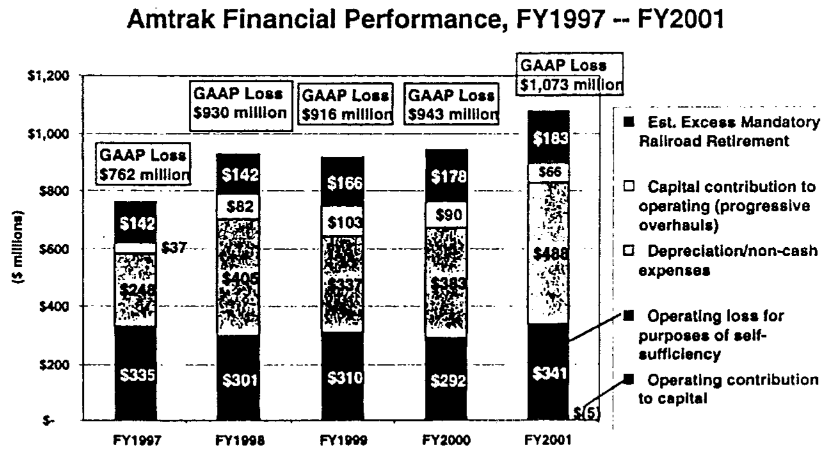
- Amtrak's costs continue to grow faster than its revenues. Amtrak has projected significant overall cost reductions in its strategic business plans since 1999, but Amtrak did not define specific cost reduction initiatives until FY2001, and those proposals total only $75 million annually, exclusive of any savings from Amtrak's planned reduction in force. These cost reductions are clearly inadequate to meet Amtrak's strategic business plan projections.

• In five years, Amtrak has made no progress toward achieving self-sufficiency and is in aweaker financial condition today than in 1997. While Amtrak made modest improvements towards self-sufficiency in FY1998 and FY2000, its FY2001 loss was its highest ever.

On January 25, 2002, the US Department of Transportation's Office of the Inspector General (DOT/IG) released its report on Amtrak's FY2001 performance. The Inspector General reached the same conclusions as the Amtrak Reform Council about Amtrak's performance, stating "Amtrak's cash losses have not decreased and Amtrak is no closer to operating self-sufficiency now than it was in 1997. With less than a year remaining in its mandate, there is not sufficient time for Amtrak to implement the kinds of sustainable improvements necessary to meet its deadline for self-sufficiency.

[3] Based on Amtrak's unaudited financial statements for fiscal year 2001. Amtrak concurs with the Amtrak Reform Council's calculations for purposes of the self-sufficiency test.

At this point in time, Amtrak will face a formidable challenge in 2002 just managing its cash resources be they from operating revenues or Federal subsidies to make ends meet without further borrowing."



- Amtrak's contentions to the contrary, simply meeting an annual target for reduced Federal operating funding does not mean Amtrak is making meaningful strides toward self-sufficiency. Amtrak has been able to continue operations with more limited Federal operating funds only by using Taxpayer Relief Act (TRA) capital funds for operating purposes and by engaging in counterproductive practices and transactions that have weakened the overall financial and physical condition of the company.[4] Federal operating grants for Amtrak may be declining, but Amtrak's losses for purposes of operational self-sufficiency are increasing. The statutory deadline of December 2, 2002, for operational self-sufficiency is not a finish line. It is instead the starting point from which Amtrak must sustain operations over the long run without Federal operating assistance.
- Despite receiving appropriated Federal funds and TRA funds totaling approximately $5 billion for Fiscal Years 1998 through 2002, Amtrak's assets are in worse physical condition now than when the ARAA was passed.
- Amtrak's inability to follow its business plans have led to imprudent borrowing, most notably the mortgaging of a portion of Penn Station New York to obtain a $300 million loan that was used to avoid running out of cash in the last quarter of FY2001. In FY2000, Amtrak also engaged in the sale-leaseback of substantially all unencumbered Amtrak equipment, which raised $124 million that had not been projected as a cash source in its strategic business plan for that year. The Penn Station loan and other borrowings, including sale-leaseback transactions, have tripled[5] Amtrak's debt since 1995, increasing its costs for debt service to about $200 million annually.
- Amtrak lacks a transparent accounting system for its operations and infrastructure, an effective reservations system that will identify seats available on Amtrak trains on a real-time basis (including reservation no-shows), and a system to measure the productivity of its use of capital, labor, energy, and materials.
- Amtrak has not made any use of the reforms enacted under the Reform Act. Amtrak has not used its Reform Act authority to restructure or eliminate unprofit-

[4] The sale leaseback of equipment in FY2000 raised approximately $124 million, and the $300 million Penn Station loan in FY2000 provided additional funds that were not in Amtrak's strategic business plans, but which helped fund cash shortfalls from business plan projections. Such additional debt and asset liens will limit future years options and sources of cash flow.

[5] Amtrak notes that its debt only doubled since 1995 if cash escrow deposits of approximately $1 billion set aside to defease (i.e., repay outstanding debt from a dedicated escrow fund) the sale-leaseback obligations are deducted from the approximately $3 billion of Amtrak debt outstanding at September 30, 2000.

able routes. It has not used its Reform Act authority to contract out elements of its operations to achieve cost savings.[6]

- Until February 7, 2002, the day the Council submitted its restructuring plan to Congress, Amtrak resisted all requests that it separate the financial statements for the Northeast Corridor Rail infrastructure that it owns and maintains from the financial statements of its train operations. The preliminary information provided by Amtrak to the Council raises important issues that need to be resolved before the information can be used for analysis.
- Amtrak lacks a strong policy to improve the intermodal connections of its system. A case in point is that Greyhound, which serves about 3,500 cities, has secured access to only 55 of Amtrak's 500 stations in the 30 years that Amtrak has been in business, and at only 35 of those 55 stations do all Greyhound buses serving that city come to the train station.

These flaws make it clear that Amtrak will not achieve operational self-sufficiency because, as an institution, it has not been able to use the past four years to get its house in order by better managing revenues, costs, and productivity. The events of September 11 are simply irrelevant to the reasons why Amtrak's financial situation has not improved over this period, and why Amtrak will fail to pass the operational self-sufficiency test.

B. Root Causes of these Problems

Amtrak's poor performance is the result of institutional flaws:

Direct susceptibility to political pressures on major and minor management decisions, which provides strong incentives to make decisions that are politically expedient in the short run, but financially crippling in the long run.

- A monopoly structure, that exhibits inherent resistance to innovation and lacks motivation to improve efficiency.
- Lack of transparency and accountability in Amtrak's management structure, accounting system, and financial reporting
- Lack of effective program administration and oversight.
- A business model based on the faulty premises of large-scale cross-subsidization and the availability of Federal funding as needed.

Lack of Congressional confidence in Amtrak as an institution, making it virtually impossible for Amtrak to secure stable and adequate funding.

Both historically and currently, the administration and oversight of the passenger rail program are ineffective. Without reform, there will be continued reliance on deficit financing with no incentives for efficiency in the conduct of operations or the use of capital. These practices will continue to fuel the debate about the efficacy of the institution, making it difficult if not impossible to secure adequate funding. Inadequate funding will continue the cycle of deterioration of assets, both equipment and infrastructure. This particularly will be true for the passenger equipment on the long-haul trains and for the NEC infrastructure. The operational reliability of the NEC will continue to degrade, introducing further train delays that will if unchecked act as a drag on the competitiveness of the regional economy of the Northeastern US (New England and Middle Atlantic). Impediments to the ability of states outside the NEC to develop their emerging high-speed rail corridors will continue.

Improvement will not come without institutional reform.

II. REFORM CONCEPTS ENDORSED BY THE COUNCIL

The Amtrak Reform Council's action plan is based on three principal concepts for reform.

a) *A New Business Model for Amtrak.* Amtrak's primary mission is the transportation of people. Today's Amtrak also establishes and administers governmental policy on rail passenger issues and is effectively the sole Federal oversight body responsible for monitoring its own business plans and operations. Amtrak also owns and maintains much of the Northeast Corridor (NEC) rail infrastructure, an asset shared with commuter authorities and freight carriers and having an economic significance that transcends Amtrak's operations. To correct these institutional failings, the Council recommends:

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[6] The Reform Act eliminated previous statutory prohibitions concerning contracting out work where the loss of a job would result, and made contracting out a collective bargaining issue. Amtrak and its unions have been in collective bargaining on the issue of contracting out since June 2000.

- Restructuring the National Railroad Passenger Corporation (NRPC) as a small Federal program agency to administer and oversee the intercity passenger rail program. In the absence of competition, a monopoly operator such as Amtrak needs government oversight. While audits of Amtrak's financial performance are regularly performed by at least three agencies, analysis and reporting functions are not a substitute for effective, hands-on oversight. Amtrak's current train operating and infrastructure functions, under the Council's plan, would be strong companies with independent boards. The NRPC would actively oversee the new train operating and infrastructure companies with respect to budget matters and approval of business plans. The NRPC would also be responsible for administering the Federal program for development of high-speed rail corridors and would have the authority, at its discretion, to introduce competition for some or all Amtrak markets.
- Organizing Amtrak's responsibilities for train operations and infrastructure as separate companies. This would allow Amtrak to focus on its mission of running trains and free it from the burden of ownership for the portions of the NEC that it owns. A separate infrastructure company would ensure that funds earmarked for infrastructure improvements will be used for the intended purpose, and will better represent and balance the needs of all Corridor users and stakeholders. The NRPC would insulate both new companies from political interference. Separation also would highlight the NEC's 20-year capital needs, estimated by Amtrak to be nearly $28 billion.

b) *The Option of Introducing Competition*. The Council's plan permits, after a transition period, the introduction of competition through the franchising of train service and NEC maintenance through a competitive bidding process. The Council believes that, as is the case throughout our free-market economy, competition would drive down costs and improve service quality and customer satisfaction.

Competition would help minimize losses, but in all likelihood would not eliminate the need for operating subsidies. Some Amtrak services—specifically Amtrak's long-distance trains would need to be offered on a negative bid basis, i.e., the bidder requiring the least subsidy would be awarded the franchise.

The Council has taken a strong position in favor of protecting the rights of rail labor in any franchise arrangement. Congress, of course, would be the ultimate arbiter of the specific labor-protective conditions that would be imposed by law.

c) *Adequate and Secure Sources of Funding*. The Council believes that adequate and secure long-term sources of funding are needed to meet the needs of the intercity passenger rail program.

III. The Councils's Restructuring Proposal

At its first working session to consider reform options, there was a consensus among the Council members that train operations and the Northeast Corridor infrastructure should be organized as separate companies and that any reform plan should include more effective government policy and program oversight. The Council then evaluated four distinct approaches for train operations: (1) national or regional operating monopolies; (2) competition for long-haul markets only; (3) competition for all markets; and (4) a regionally-managed, operationally self-sufficient rail passenger network.

The Council considers all of the options meritorious, but specifically endorses option 3, with respect to train operations. The most significant amendment makes the introduction of competition permissive rather than mandatory.[7]

THE COUNCIL'S PROPOSAL THUS HAS THREE ELEMENTS:

1. *Federal Program Management and Oversight*. The Council recommends that the administration and oversight of the national passenger rail program be conducted by the National Rail Passenger Corporation (NRPC),[8] which would be restructured as a small government corporation. The NRPC would operate at arm's length from Amtrak's current train operations and infrastructure, which would be organized as companies with independent boards of directors. While it may be more appropriate for these companies initially to be subsidiaries of the NRPC, over the long term they would function more appropriately as separate companies. The

[7] A matrix summarizing the major elements of each of the proposals may be found at the end of Chapter IV.

[8] The name National Rail Passenger Corporation is retained to make clear that it is intended to be the legal successor to the existing NRPC. Under existing law, the NRPC holds Amtrak's statutory right to operate over the lines of the freight railroads at incremental cost and with operating priority, and such rights would be retained by the restructured NRPC.

NRPC's board of directors would comprise representatives from congressionally-defined regions covering the entire US (the governors of each of the regions would propose candidates to the President, for nomination to the Senate), the Federal Government, the railroad industry, and railroad labor. NRPC would hold the statutory franchise to operate over the rights-of-way of the freight railroads at incremental cost with operating priority, and would authorize the train operating company or other service providers to operate under the franchise on its behalf.

The Council recommends that the NRPC be modeled after the United States Railway Association (USRA), and be charged to administer and oversee the intercity passenger rail program. USRA was formed by the Congress in 1973 to plan Conrail and monitor its performance. USRA reviewed Conrail's business plans, monitored its progress in executing its plans, disbursed Federal funds, and had the authority to withhold funds if Conrail did not take actions to improve its performance. USRA enforced discipline, shielded Conrail from political interference, and, by working closely with Conrail management, contributed to Conrail's success. The Council believes the passenger rail program would benefit from a similar oversight organization.

The NRPC would also:

- Administer Federal funds made available for intercity passenger service;
- Administer the development of high-speed rail corridors, including evaluating project proposals and prioritizing projects for design and construction;
- Oversee the business plans of the train operating and infrastructure companies;
- Divest non-NEC physical assets (e.g., stations and track) to states and localities;
- Determine whether to franchise train services and/or maintenance of the Northeast Corridor, design franchises to be offered, administer the competitive bidding process, and administer contracts with franchisees; and
- In cooperation with Congress, the States, passenger and freight railroads and the public, manage public policy issues with respect to rail passenger service.

2. *Train Operations*. There should be a separate company ("Amtrak") organized to provide train-operating services. Amtrak's train-operating services, including passenger and mail/express operations, equipment repairs, and commuter operations, should be provided by contractual arrangement with Federal or State authorities. NRPC would appoint its board, which would be comparable to the board of a major transportation operating company, such as an airline.

Amtrak operates a number of services today under contract with State departments of transportation and commuter authorities and these contracts to operate services franchises are a model of how franchising can work. Amtrak's responsibilities are clear and none of these services involve unfunded mandates to operate particular routes without adequate compensation. The Council recommends that contracts for train-related services require continuous improvement in specified performance measures such as cost recovery, customer satisfaction, and ridership. And train operations, mail and express, the equipment repair shops, and commuter services should each have transparent accounting. Amtrak must become more efficient either by meeting the terms of a contract or through the eventual introduction of competition.

The Council's plan would permit a pilot project to be implemented immediately by the NRPC to gain experience with franchising. Otherwise, Amtrak would be given two to five years to "get its house in order" before competition could be introduced. During this transition period, the NRPC would design appropriate franchise units, seeking input from State authorities, the freight railroads, Amtrak and others.[9] Terms and conditions for franchising would be developed during this period and decisions made about how to manage the bidding process. Any exercise of franchise authority by the NRPC would be specific in its terms, would be based on consultation with all concerned parties, and would require that adequate capacity exist for both passenger and freight requirements before any expansion of services would be implemented.

After the initial transition period, the NRPC would have the authority, at its discretion, to franchise some or all Amtrak train operations, including mail/express. Franchises would be offered through a competitive bidding process and would provide exclusive rights to operate passenger and mail/express service. Franchisees would operate under the NRPC statutory franchise and would be afforded the same liability protection and access to insurance currently available to Amtrak. Ultimately, Amtrak, as the train operating company, could be privatized.

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[9] The Council envisions a relatively small number of franchises to avoid cherrypicking of Amtrak's routes.

All franchisees would be subject to the Railway Labor Act, FELA,[10] and railroad retirement. Current Amtrak employees would be granted hiring preference with new franchisees to the extent that hiring is necessary. The Council recommends to Congress that in any restructuring, employees follow their work in seniority order with their collective bargaining agreements intact. Agreements would be subject to collective bargaining under the normal provisions of the Railway Labor Act. Labor protection would be provided by the NRPC under the terms of the then-existing collective bargaining agreements.

After transition, the Amtrak shops could be sold, leased to private entities, or operated or disposed of by the NRPC. Alternatively, train operators might bid to operate equipment repair shops as part of a franchise or contract with the shops for equipment maintenance. The equipment itself could be either owned by or leased to franchisees.

Federal operating subsidies to support train operations after the transition period would be available only for the long-distance trains that are Amtrak's most unprofitable operations. Shortfalls on non-national system routes, including new high-speed corridor services, would be the responsibility of the States after a transition period. The Council believes equipment capital should be funded through private financing, if possible.

3. *Infrastructure*. The Council recommends that Amtrak's Northeast Corridor infrastructure assets be organized as a government corporation that would control corridor operations, perform maintenance, and implement capital improvements. The company's board of directors would comprise representatives from the States along the Corridor, the US Department of Transportation, freight railroads operating on the Corridor, and the intercity passenger service provider. The Corridor would be managed as a shared regional and national asset.

As with Amtrak's train operations, the infrastructure company would operate under a contractual agreement with the Federal Government. Performance standards would require continuous improvement in specified performance measures. After a two- to five-year transition period, the NRPC could authorize the NEC company to franchise its functions through competitive bidding.

Track use fees would continue to be based on incremental costs for passenger operators with other users paying negotiated rates. Incremental cost is the standard that applies to intercity passenger services off the Corridor and for that reason is retained as the standard on the Corridor.

Significant capital funding is needed for the NEC infrastructure. While the Northeast Corridor is operationally self-sufficient under the standards of the Reform Act, the infrastructure company will not be able to fund its own capital needs. The Council's plan endorses Federal funding but also expects the States to fund a portion of the need in recognition of the Corridor's importance to regional and commuter rail operations.

IV. Issues and Options for Improvement of Rail Passenger Funding

I would like to offer some comments about the funding issue, regarding both the entire passenger program and the NEC infrastructure.

There are no easy answers to funding rail passenger service. But it is clear that given the size of the needed investment, reform of Amtrak is essential to minimizing costs and protecting the taxpayers investment. It is also clear that all of the stakeholders in intercity passenger rail service the Federal Government, the States, Amtrak and its employees, the commuter authorities on the Northeast Corridor, the freight railroads, and the public will need to make a contribution for the program to move ahead. A number of proposals have been advanced to fund capital needs. The Council has taken no position on these proposals but supports adequate and secure sources of funding for intercity passenger rail service.

As the Council began to carry out its mandate, it became increasingly clear that the environment in which Amtrak was functioning had begun to change around the time the Amtrak Reform and Accountability Act of 1997 was signed into law. Without making any judgment, I think it is fair to say that the advent of guaranteed spending programs in transportation has limited the ability of the Appropriations Committee to address other worthy transportation projects. For the most part, Amtrak depends upon on the availability of Federal funds as authorized by this committee and appropriated in the annual Transportation Appropriation bill. However, in recent years, appropriators have had less discretion to find resources to fund transportation programs not included in guaranteed spending programs. That has

[10] Federal Employer's Liability Act.

left Amtrak to compete with the Coast Guard, DOT, safety programs and a variety of independent agencies for whatever funding is left over.

Several years ago, the Congress addressed serious program and funding issues affecting Amtrak when it drafted the Amtrak Reform and Accountability Act of 1997. Remember, it was the enactment of the ARAA that allowed Amtrak to access the $2.2 billion in the Taxpayers Relief Act for a "tax refund" for capital improvements. In addition to the reforms, this legislation also provided Amtrak with an authorization of approximately $1 billion per year, on average, for five years.

For whatever reason, Amtrak chose not to ask for an appropriation equivalent to what had been authorized in the first or any succeeding year until now. We all know the value of hindsight but it is now clear that if Amtrak had succeeded in establishing a benchmark appropriation nearer to what had been authorized, it may have been able to establish a foothold in the appropriations process that would have allowed it to address much of its infrastructure needs in that first year and subsequent years.

As a result, the pattern for Amtrak appropriations was set in 1998 and after four years the total average appropriation received by Amtrak is actually closer to about half of that amount included in the authorization legislation enacted. While no one will ever know if that additional appropriation would have forestalled the bleak financial condition we find Amtrak in today, it certainly would have helped address some of the important capital projects that could have reduced costs or minimized the estimated $3 billion backlog of "state of good repair" needs in the Northeast Corridor. Frankly, Mr. Chairman, I was a little surprised to hear Amtrak, in its press conference on February 1st, blame Congress for not providing enough funding.

A. AMTRAK'S REQUEST FOR $1.2 BILLION FOR FISCAL YEAR 2003

Amtrak's "Fiscal Year 2002-2003 Business Plan, Fiscal Year 2003 Legislative & Grant Request" once again assumes significant operating improvements so that all but $200 million of its $1.2 billion Fiscal Year 2003 Grant Request is for "Capital" (including maintenance of equipment and maintenance of way) purposes rather than for operating losses. Amtrak states that, "Leading up to the current fiscal year, it was clear that in the absence of aggressive management action, these challenges would combine to create an operating gap of $550 million—even after factoring in previous cost management efforts and faster growth in the new Acela service." To address this gap, Amtrak indicates that it developed a program to further reduce expenditures, including $195 million in cost management initiatives. It also identified $356 million in revenue enhancement, financing transactions and commercial project initiatives. Amtrak claims that its $550 million of "baseline challenges were therefore addressed in full, with an aggressive business plan that was put in place on October 1, 2001."

Following the September 11 attacks, there were additional risks that resulted (according to Amtrak) in further immediate cuts in operating costs in Fiscal Yeaer 2002 of approximately $111 million and deferrals in capital investments of approximately $175 million.

Historically, Amtrak's business plan projections of operating improvements have been optimistic, with operating losses frequently higher than projected. Amtrak has funded those losses by deferring capital expenditures or by entering into asset financing transactions to make up the shortfalls.

One likely source of additional operating losses is the 18 long distance trains that Amtrak anticipates will require a $200 million subsidy in Fiscal Year 2003. Amtrak states, "The projected operating loss from the 18 routes is about $360 million (after cost reductions) [emphasis added] of which $160 million is covered by internally-generated cross-subsidies and the remaining $200 million represents a net funding need. . . ." In Fiscal Year 2001, Amtrak's 18 long distance trains (excluding the Auto Train) had an operating loss of approximately $700 million including depreciation and their allocated share of excess Railroad Retirement Taxes. If depreciation and their share of excess Railroad Retirement Taxes are excluded, they had a loss of approximately $470 million. Giving Amtrak every benefit of the doubt, implicit in Amtrak's Fiscal Year 2002-2003 Business Plan and Fiscal Year 2003 Grant Request is a $110 million improvement in the profitability of the 18 long distance trains coupled with the availability of another $160 million of "internally-generated cross-subsidies." Based on prior experience, Amtrak once again is requesting capital funds, but risks having to use a significant portion of those capital funds to cover cash losses that are likely if the 18 long distance trains continue in operation during Fiscal Year 2003.

The chart below, which summarizes Amtrak's Fiscal Year 2003 Funding Request and Other Capital Investments, assumes significant improvements in operating performance from actual performance in Fiscal Year 2001. The $1.2 billion funding request, including mandatory debt principal repayments and allocated shares of excess Railroad Retirement Taxes, is anticipated to be used as shown: $544 million for the Northeast Corridor infrastucture and train operations; $251 million for other corridor trains; and $405 million for long distance trains.

AMTRAK FY2003 FUNDING REQUEST AND CAPITAL PROGRAM

	Total FY2003 Request	NEC Boston To Washington	Other Corridors	Long-Haul Trains
OPERATING (Deficit from Long-haul trains)	200			200
BASIC CAPITAL				
- Mandatory Debt Principal Payments	105	19	31	55
- Mandatory (environmental, ADA, 180-day insp.)	265	95	95	75
- Infrastructure Safety/Reliability	360	305	55	0
- Fleet Overhauls/Other	110	35	50	25
- Subtotal, Basic Capital	840	454	231	155
EXCESS RAILROAD RETIREMENT TAXES (a)	160	90	20	50
TOTAL AMTRAK REQUEST FOR FY2003	1,200	544	251	405

OTHER CAPITAL INVESTMENTS IDENTIFIED BY AMTRAK IN FEBRUARY 2002 LEGISLATIVE REPORT

- Capital Backlog - For deferred NEC Infrastructure	3,800	3,800		
- Capital Backlog - For stations & facilities	900	(b)	(b)	(b)
- Capital Backlog - For the equipment fleet	1,100	(b)	(b)	(b)
- Capital Investment - To develop 11 federally-designated corridors including $9 billion for speed and capacity growth on the NEC	50,000	9,000	41,000	0

(a) Amtrak Reform Council allocation based on Amtrak FY2000 Wages And Overtime Employment Costs for NEC costs and allocating remaining $70 million of RRTA costs based on Amtrak's RPS Train-Related Expenses for 18 long-haul trains and Train-Related Expenses for other corridor trains. Rounded to nearest $5 million.
(b) Amtrak provided no basis for allocation of these capital expenditures to specific corridors or business units.

B. Funding for the Operating Company

The cost to fund intercity rail service will be considerable. Based on its Fiscal Year 2001 cash loss, Amtrak's Federal operating subsidy could approach $600 million annually (with Amtrak currently receiving another $125 million in operating subsidies from States). Additional operating subsidies could be needed for high-speed corridors if ridership and revenue targets are overly optimistic. The Council's plan would minimize operating subsidies by creating incentives for cost containment and efficiency either through operating contracts with Amtrak or franchising. The plan also recommends that, after a transition period, Federal operating subsidies be limited to long-distance "national" trains; States would bear the cost of operating subsidies for corridor services, including new high-speed services.

The Council believes that, if train operations are separated from infrastructure and trains are operated under contract (which will occur even if franschising is not initiated), private capital markets are likely to play a much larger role in financing passenger equipment.

C. Funding for the Infrastructure

Infrastructure investment needs are even greater. The Northeast Corridor infrastructure is in need of about $1 billion annually in capital funds. According to Amtrak's estimates[11], the cost to develop all of the high-speed corridor projects that have been advanced by the States amounts to $70 billion, or $3.5 billion per year over twenty years. These spending levels may be unrealistic in today's budget environment.

[11] In the Fiscal Year 2003 Legislative Report that Amtrak issued earlier this month, it indicates a level of corridor spending of $50 billion over 20 years, including $9 billion for improvements to the NEC, but excluding $3.8 billion of deferred NEC infrastructure investments.

As you now know, the Administration's budget for fiscal year 2003 proposes $521 million for Amtrak, the same level provided in this fiscal year and continuing the pattern established in 1998.

Now the Federal Government is facing deficits and there is intense pressure on the transportation budget to deal with aviation security, increases in Coast Guard funding and significant shortfalls in Federal fuel tax revenues that fund highway programs. This is not an environment in which Amtrak will be able to reverse the appropriations trend and obtain the resources it needs to fund critical infrastructure projects in the Northeast Corridor. It was this fact, among others, that led many on the ARC to conclude that Amtrak, as the owner of the Northeast Corridor, is simply not in the best position to access the capital the NEC requires for critical improvements.

Clearly, I do not need to demonstrate to this committee how difficult it is for the Federal Government to address important transportation funding decisions when the bulk of these funding decisions are now set by statute. This environment dictates that we must begin to consider other alternatives to finding the capital requirements for the Northeast Corridor.

If Amtrak were relieved of its obligation, as the owner of the corridor, to provide the capital and human resources necessary to keep it in a state of good repair, it would have an immediate and positive impact on Amtrak's bottom line. We believe, as the Administration stated in its recent budget submission, that a "Federal, State and private partnership" would be best suited to address the staggering capital needs now required in the corridor.

Two additional factors need to be considered when weighing the policy decision on Amtrak ownership of the Northeast Corridor. First, any company faced with the level of operating losses and debt that Amtrak has experienced will frequently feel a sense of desperation about minimizing its losses. In the past (according to the DOT/IG in its January, 2002 report), when Amtrak had a large base of capital funds (like TRA), it allocated indirect and overhead costs that were initially recorded to the company's operating expenses to capital projects through the application of an overhead rate for capital project-related labor and material expenses. While this may be a legitimate accounting mechanism, it masks one of the difficulties of having an operating company that is experiencing operating losses also being responsible for making capital improvements to its infrastructure. It may be too difficult to avoid the temptation to shift operating expenses to capital projects. The result is that Federal capital dollars lose their full impact when the opportunity exists for this type of accounting to be employed. The other concern is also related to an operating company that is experiencing losses. A case in point is that its ownership of the NEC infrastructure led Amtrak to make the poor financial decision to mortgage portions of Pennsylvania Station in New York over a 16-year period in return for three months of operating expenses. This example could be a case study for any business school in the country on how not to conduct business. These examples alone would be enough to consider separation.

So, Mr. Chairman, looking at these facts we have concluded that the current structure of Amtrak as a rail passenger operator and owner of the Northeast Corridor has not worked in the past and is a formula for disaster if it is allowed to continue without restructuring. With Amtrak being unable to obtain the funding necessary for corridor improvements, the corridor will continue to deteriorate and ultimately will become a safety threat to the hundreds of thousands of people that use it every day. If the status quo continues, it is only a matter of time before we reach a crisis point and the infrastructure requirements will require a heavy toll on the Federal Government. At a time when the Federal Government is preparing to make major investments in homeland security, it should not walk away from confronting the safety issues in one of its critical transportation assets.

There are no easy solutions to restructuring Amtrak and our goal should be to take a step back and look at the system as a whole and make a determination on what works best for the various components of the system. That is what we have tried to do. No matter what the Congress decides to do about Amtrak one thing is very clear the Northeast Corridor will continue to exist, with or without Amtrak, and the first objective of the Federal Government must be to take steps to assure that a proper level of investment is achieved through Federal and State Governments and, possibly, through public-private partnerships. It is in everyone s best interest to place the responsibility of the corridor in a position where it has the best chance to access funds, and where it will have the least impact on the financial performance and financing requirements for both operating and capital of the new train operating company. Based on historical funding patterns, particularly in recent years, having Amtrak as the owner of the NEC may be the worst outcome.

V. Potential Source for Funding the NEC Infrastructure

Separating the Northeast Corridor infrastructure both organizationally and financially from Amtrak's nationwide train operations is another way of closing the gap between the subsidy needs of Amtrak's train operations and the uncommitted funds available in the budget. The other side of this coin is that leaving most of the Northeast Corridor under the ownership and funding of Amtrak will continue the inadequate funding and perpetuate the deterioration of this vital NEC infrastructure. There is little or no chance that Amtrak will be able to get the capital it needs to maintain and improve the NEC out of appropriated funds.

The Council's February 7, 2002, Action Plan included a detailed list of funding options for the NEC rail infrastructure. These options were from a preliminary report on NEC funding options that BGL Rail Associates provided to the Council.[12] The final BGL recommendations identified three major advantages in securing capital funding that would accrue to the NEC infrastructure if it is separated from Amtrak's train operations, as the Council proposes.

First, a separate NEC could apply to the management, operation, maintenance, and improvement of the NEC infrastructure about $500 million in annual funding generated by the NEC infrastructure (not by fare-box revenues from Amtrak's train operations). That's a number that you might not have heard before, This $500 million comprises several categories of income: (1) about $215 million in annual non-train-operating income generated by the NEC; (2) about $90 million in track use fees from commuter and freight railroads; (3) an estimated $160 million in track use fees that Amtrak's trains would have to pay for using the NEC tracks on an incremental cost basis; and (4) capital contributions from commuter railroads of about $30 million.

Second, a separate NEC would, through the states on its board, have some access to the flexible provisions of the transportation trust funds. Those trust funds, also called guaranteed spending programs, currently control 75 percent—let me repeat that: 75 percent—of *all* Federal transportation funds, and they are funds that Amtrak can not access.

Third, a separate NEC could access other sources of incremental funding for infrastructure that Amtrak cannot access. There is no single "silver bullet" source of government financing that can meet the Corridor's annual needs for investment. To quote the BGL report:

"Even if more funds were authorized for the NEC, the chances of more funds being appropriated are not good. Our analysis of capital needs and the likely sources of funding indicates that only through a coordinated program of new ownership with broad participation of users can the NEC users expect to achieve the operating level the NEC requires and that the region's transportation needs justify. A change in ownership is essential because Amtrak has demonstrated that it cannot obtain the level of funding necessary out of Federal appropriations. Participation of all owners and users in the identification of logical funding sources can result in a concerted effort to achieve a multi-year capital improvement program using multiple sources of funding."

Some of the sources of incremental funding that could be considered to support the multi-year NEC improvement program for a NECRIC are:

- Bond authority in legislation currently pending before Congress appears to have bipartisan support and is a logical source for addressing some of the critical Northeast Corridor infrastructure projects. H.R. 2950 and S. 1991 would be effective if States used their discretion to exercise those programs.
- Tax incentives for public interest rail projects like those being proposed by the Association of American Railroads could generate private sector investments in the NEC and take some pressure off the appropriations process to find all the funding required.
- Creative partnerships with private sector entities such as "design and build" agreements with engineering construction firms and Regional Transmission Organizations could be a means to build much needed electric transmission lines in the Northeast. Such partnerships could implement the $800 million catenary replacement program on the south end of the corridor.
- Turning over portions of the corridor that are used primarily by commuter services (like the Penn Station New York Complex) to local commuter authorities would shift many of the associated maintenance costs and capital expenditure requirements that are now dependent on Federal appropriations to other sources.

[12] The BGL report to the Council is available, as is the Council's Action Plan and its other major reports, on the Council's website at <www.amtrakreformcouncil.gov>.

- Reauthorize the Northeast Corridor Improvement Project (NECIP) to provide Federal funding for life safety/security concerns on the corridor.

Other sources of funding might be added to this list. Such additions are possible during next year's reauthorization of both the Transportation Equity Act for the 21st Century (TEA-21) and the Aviation Improvement Act for the 21st Century (AIR-21).

It would make sense for Congress to expand the flexibility provisions in TEA-21 and similar flexible provisions in the Aviation Trust Fund where NEC improvements would relieve capacity and congestion restraints of major highways and airports. The NEC serves cities with four of the seven most congested airports in the US, and it parallels Interstate 95 for much of its length. Today, the NEC's intercity passenger, commuter, and freight rail operations help reduce regional highway and airport congestion, thus justifying flexibility so that these programs can assure the availability and value of an alternative mode of freight and passenger transportation.

VI. Conclusion

Mr. Chairman, the Council believes its recommendations are strong and sound. The chronic difficulties that Amtrak experiences year in and year out are not due principally to lack of funding. They spring primarily from an organization that is obsolete, that cannot do all the things that it is charged to do, that will not consider recommendations for change, and that desperately needs to be redesigned.

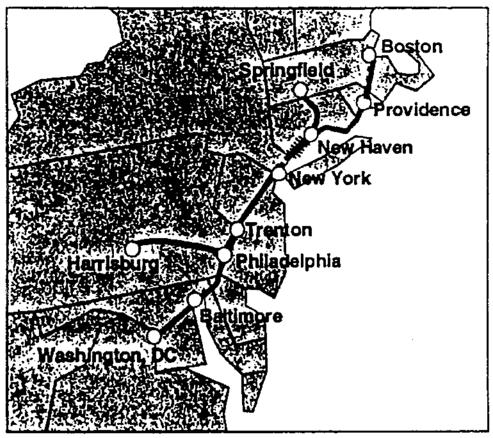
For these reasons, the Council strongly recommends that the Congress first adopt badly needed institutional reforms before providing major new funding for passenger rail service.

Once such reforms are adopted, the Council is convinced that the new structure will make the investment needs of rail passenger service much easier to understand. The new structure will also be much more conducive to effective financing by Federal, State, and local governments and by private capital markets.

I stand ready to answer questions and address issues that the Congress might want to pursue. The Council thanks you, Mr. Chairman, for the opportunity to address the committee.

Appendix

Northeast Corridor Ownership



Amtrak (366 miles)
NY MTA (New Rochelle, NY to NY-CT state line) (10 miles)
State of
Connecticut (NY-CT state line to New Haven, CT) (46 miles)
Commonwealth of
Massachusetts (RI-MA state line to Boston (38 miles))

Chairman CONRAD. Thank you, Mr. Till, for that testimony.

Can you tell me a little about the Amtrak Reform Council? How did that come together? And what is the genesis of the Reform Council?

Mr. TILL. A series of events in the mid–1990s led to the enactment of a law called the Amtrak Reform and Accountability Act, which provided about $5 billion in authorized funding for Amtrak and which also had the effect of releasing about $2.2 billion of a so-called tax refund that Amtrak was authorized to get under the Taxpayer Relief Act of 1997.

As part of that law, the Congress mandated that Amtrak should achieve operational self-sufficiency, and that means that if you look at the normal income statement of a corporation, in Amtrak's case you could take out about $600 or $700 million worth of expenses and they wouldn't count against being "self-sufficient" on an operational basis.

To oversee Amtrak's progress towards self-sufficiency, to advise the Congress of that process, to monitor Amtrak's financial and operational performance, and, finally, to suggest recommendations for Amtrak to improve so that it might make better progress towards self-sufficiency, the Amtrak Reform Council was authorized and created under that act.

It took about a year and a half for it to get into effective operations, until the early spring of 1999, and that was after a period when Governor Christie Todd Whitman of New Jersey had been appointed to the council and had become its chairman. Difficulties in receiving funding for the council led her to resign, and the council's current chairman, Mr. Gilbert Carmichael, was elected by the other members of the council. He has been the chairman ever since, and the council's basic approach has been very simple, to take a two-track approach: one is to monitor Amtrak's performance and identify its problems and what recommendations can we make [for improving its performance] and the other is to look at more fundamental problems and identify the things that the Congress should be advised of. Another one of the mandates that the council has, is to advise the Congress of changes that should be made in the laws pertaining to Amtrak.

Chairman CONRAD. And what is your position there, Mr. Till?

Mr. TILL. I am the executive director. I am the chief of the staff that the council has selected.

Chairman CONRAD. And how long have you been there?

Mr. TILL. I have been there about almost 3 years.

Chairman CONRAD. OK. Let me ask you this: Do you think it is a realistic goal that the passenger rail system be self-sufficient?

Mr. TILL. I think parts of the passenger rail system can be self-sufficient, but I think it is very difficult to take a nationwide train operation and a monopoly construct without any oversight, without any transparency or accountability, and to tie to it an enormous piece of infrastructure on which that company is a minority operator and expect that the company is going to be able to manage itself or that people will be able to understand effectively what is happening in that company.

I can tell you that in late 1999 the council requested that Amtrak provide a simple set of financial statements. Tell us what your income statement is for the Northeast Corridor infrastructure, and tell us what all your train operations look like. We got that statement, in a form that could not be used, on the day we submitted our restructuring plan to the Congress, on February 7th of this month. And that gives you an idea about Amtrak's responsiveness to any notion of oversight.

Let me just very quickly answer exactly, yes, parts of it can be self-sufficient. Most of it can be much more efficient than it is right now. And the key to doing that is to organize it the way that the council recommends. You don't have to follow our exact recommendations. There are a number of people who are going to make proposals that will be consistent with this because we have got to get the States into the business of making transportation decisions.

You will find that the surge in transportation ridership on rail has been driven in the 1990s by States and groups of States, in the Pacific Northwest, in California, in New York, in the Midwest, and in Florida and in North Carolina. These are the States that are leading the way, and these are the people who are driving Amtrak's most effective operations, with the best customer service, and with the highest satisfaction rate.

Chairman CONRAD. Mr. Till, can you tell me, I have always—I have often wondered—I am not expert in this, so you are educating me and I appreciate that. It has always struck me that, in terms of nationwide passenger rail system, it seemed an unrealistic goal that that be something that could be self-sustaining. And I don't doubt for a minute that the efficiency could be improved with perhaps some of the changes that you have recommended here.

As I understand it, you are talking about splitting this into three different operational entities. Is that correct?

Mr. TILL. What we have today is a single National Railroad Passenger Corporation, which under the Amtrak Reform Act is now technically a private corporation. When the National Railroad Passenger Corporation was originally created under the Rail Passenger Service Act of 1970, it was so-called mixed enterprise/government corporation.

The council believes that the actual Government functions that this corporation performs—and it has a number of major governmental-type functions—should be placed in a restructured National Railroad Passenger Corporation, which would be a Government corporation, and that corportation would spin off the train operations and the infrastructure.

Chairman CONRAD. OK. Let me stop you right there. I am sorry to be taking this time. I have another appointment I am going to put off here because, while we have got you here, I would like to get the benefit of your experience.

Mr. TILL. I appreciate it very much, Mr. Chairman.

Chairman CONRAD. You have talked here about a governmental function. Can you describe that further?

Mr. TILL. The main purpose of the Rail Passenger Service Act of 1970 was to take about $500 million in operating losses for passenger services off the backs of America's private railroad industry. They were already reeling from the highway program, from the development of aviation, from the growth of the trucking industry, and as a result, they started losing more and more money. So they came to the Government and said, Please take this passenger load off of our backs, and that is indeed why Amtrak was created. So you end up with a company that was created for a negative reason, not for a positive reason.

To make sure that it could operate, the Government extracted from the freight railroad industry a power for this National Railroad Passenger Corporation that it would have the authority to operate trains over their network at incremental cost and with priority over freight operations. So that is a Government franchise right that is very important.

Chairman CONRAD. I see, yes.

Mr. TILL. Also, the direct access to the Congress for purposes of seeking funding, which Amtrak has under statute, is a governmental prerogative. And the notion that both the company or the entity that does that and the entity that runs trains should be tied directly to the Congress may give you some insight into why it has been so difficult to manage it effectively over 30 years.

Chairman CONRAD. OK. So you would split off that part. Now, you made a reference to infrastructure that I didn't fully understand, and I want to make sure we have got that understood in the record.

Mr. TILL. Yes, sir.

Chairman CONRAD. You made a reference to splitting off this governmental—in effect, governmental responsibilities, passenger rail infrastructure, and earlier you had made a reference to infrastructure that I didn't quite—I didn't fully understand. Do you recall your earlier reference to infrastructure?

Mr. TILL. When we talk about infrastructure, we are talking about—primarily we are talking about in terms of what is the so-called 800-pound gorilla in Amtrak's infrastructure zoo—the Northeast Corridor infrastructure, which is in a terrible state of repair and is absolutely vital in the Northeast. They also own substantial infrastructure in little bits and pieces around the country. Now—

Chairman CONRAD. The infrastructure—let me make sure—and the Northeast infrastructure, they own that but others use it?

Mr. TILL. They own part of it. They own about 366 miles out of 460. Massachusetts owns the part that is in Massachusetts. Connecticut owns 46 miles of the Northeast Corridor that is in Connecticut [from New York to New Haven]. And New York owns about 12 miles between a place called New Rochelle interlocking and the Connecticut border. And those happen to be, Mr. Chairman, the portions of the corridor that are actually in the best condition. But there is another reference to infrastructure I made, and that is that, if the Congress is to move forward, as is proposed under, I would think, the Young bill [H.R. 2950] and certainly under the High Speed Rail Investment Act [S. 250] proposed by Senators Daschle and Lott, and from the development of infrastructure improvements—track and signals and other improvements that are necessary to improve the speed and capacity of tracks that are owned by the freight railroads so that you can have better and more extensive passenger service, you know, throughout the country—in these so-called emerging high-speed rail corridors—then that is also another element of infrastructure that is involved in this. And eventually the infrastructure funding for rail, I think the council believes, ought to be all put on the same footing. But right now, with the Government having $4 billion in liens on the Northeast Corridor and Amtrak being $3.3 billion in debt, it is hard for the Government to get disentangled from that Northeast Corridor infrastructure. Amtrak has had that infrastructure—it didn't start with that infrastructure—it got that about 5 years after Amtrak was created. It got it when Conrail was created, when Conrail, or USRA on behalf of Conrail, said, that is too big a burden and Conrail doesn't need that expense and you need to give that to somebody else, Mr. Federal Government. So—yes, sir?

Chairman CONRAD. I want to make sure I understand this. So one of your recommendations is that the infrastructure piece of that be under a separate umbrella. Is that correct?

Mr. TILL. Yes. And, in fact, there is some talk—and in the Amtrak Reform Act, there is a provision that provides prior Federal approval of interstate compacts for rail facilities. We looked at the possibility of having the States of the Northeast Corridor form an interstate compact to own and operate the Northeast Corridor. In the process of doing that, we talked to a woman by the name of Anne Stubbs, who is the executive director of the Conference of Northeastern Governors, which has offices right over here on North Capitol Street. She has indicated that they had worked for 18 years, or something like that, well over 10 years, to try to put together a northeastern energy compact that would have the same status as an interstate compact for this rail facility. And she said they hadn't been able to do it.

So our proposal is that to put this infrastructure into a separate Government corporation and put on its board the Northeast Corridor States, who would probably appoint their commuter operators to it or their secretaries of transportation, put on it a representative of the freight railroads, put on it a passenger train operating company representative—

Chairman CONRAD. Who would be opposed to that?

Mr. TILL. I think that a good deal of fear and trepidation—of the sort that you are hearing at this table today from people who are worried about highway funding and other things—would also attend to the notion of splitting this off and putting it primarily under the responsibility of the States. There will have to be some Federal funding. But right now, as I indicated in the testimony, if only 25 percent of the funds are available for non-guaranteed spending, then having this piece of infrastructure get all of its funding needs out of that 25 percent, it is not going to happen.

And so the fact of the matter is that as we move into TEA–21 and Air–21 reauthorization next year, these are the kinds of issues that are going to have to be raised, and not just for the rail passenger program, for a whole lot of issues having to do with urban transit and other infrastructure.

So this is all part of an evolving situation in which we need a better institutional structure for rail passenger service so that it can more effectively participate in terms of infrastructure development by the Federal Government, by States and localities, and in terms of any operational funding that is going to be necessary to operate train service that, quite frankly, the Congress may require as part of its vision for a reformed rail passenger program.

Chairman CONRAD. You know, a lot of what you say makes a great deal of sense to me. Again, I am not an expert in this area. I don't pretend to be. I have got an obligation to try to understand it better, and that is the reason we wanted this as part of the hearing today. And, again, I appreciate your being here.

You know, as you describe this, I wonder what would be the effect on a State like mine, where we have Amtrak service, I would presume, that is subsidized, because I don't know how you could run these long-haul passenger rail systems. If that were split off and put out as part of a rail passenger system, what do you think would happen to these long-haul—

Mr. TILL. Well, let me give you the scholarly answer to that question based upon looking at what has happened for similar operations around the world let me also. And give you a very practical example of what happened when a company came in and said to us, Here is the map of a restructured long-haul network that we would propose to run, we will get private financing for it, enough to cover operating losses for about 5 years. And we think under this construct that we could actually make money, with the combination of luxury service, coach service, and passenger rail express service, but to do it in a way were you are actually moving where people move and where freight moves, the kind of premium freight that Amtrak has actually led the way in identifying the market for. They do provide very important premium freight services out there, but just as the council had indicated, you have seen the ears perk up on the freight railroads, and they are saying, Hey, if Amtrak can make that much money, then maybe we can make that much money, too. And so they are going after the same sort of traffic where they can compete effectively.

So you do have people out there who think they could make a go of it. An experience in Australia where they restructured that kind of operation actually has proven that out. There are trains in Australia that operate long-haul services, probably not on a scheduled basis but on a periodic basis, that are private—profitable in the private sector.

Now, if you wanted to blend those two kinds of operations, maybe someone could come together and say I will put together a package in which, maybe the train company—the Burlington Northern or the Union Pacific—would say, well, we will operate the trains and we will organize the mail and express traffic and hire some cruise line to organize the luxury service and let the national train operating company, Amtrak or somebody else, provide the coach service.

So there are lots of different opportunities. In fact, Amtrak itself even participated in bidding on one of the franchises that was let for long-haul passenger operations in Australia. So people are out there who want to do it, and it has been successful, and I think in the best case you can cut your operating losses by about 50 percent, and in a more conservative way, I think you could say we would be looking at something between 20 and 30 percent in terms of improved efficiency and loss reduction with a properly managed long-haul system. So that kind of long-haul passenger train would be less difficult to fund if the Congress decides it wants to move ahead.

Chairman CONRAD. Let me just say I have got to bring this to an end. I wish I didn't have to, but scheduling requirements compel me to do that. I have found this discussion very interesting, and I want to thank you very much for coming. I thank you for your patience here today.

You had a whole series of ideas on funding that I also found interesting because I agree with you, this is not going to happen just on Federal appropriations. I mean, if we reality-test here, it is not going to happen. We don't have the money. And I can't foresee any time now in the near future where we are going to have the money to do all that is required. And the needs out there are enormous. I don't know what the correct number is with respect to the Northeast Corridor. You used a number of some $3.4 billion of infrastructure backlog. Was that—

Mr. TILL. It is 3.8. That is pretty vital stuff. It includes life/safety problems, tunnel problems in Penn Station, New York, and—

Chairman CONRAD. What period of time would that be?

Mr. TILL. I think the backlog has grown up gradually over the whole 25 years. It has probably built up—

Chairman CONRAD. That $3.8 billion, that is immediate needs? Those are—

Mr. TILL. If you had a program that could put that into—you know, begin to implement that immediately, you could spend it all. But, you know, obviously there is—

Chairman CONRAD. Yes. Well, I think I kind of like this list. In fact, I made notes of things that you mentioned in terms of a combination of ways of addressing this, because I think it is going to take a combination.

Mr. TILL. Well, Senator, I think, you know, we didn't have a lot of lead time to prepare this, and I will get a revised version of this that is cleaned up and a little bit more succinct. I will provide that to the committee.

Chairman CONRAD. That would be very useful to us.

Mr. TILL. And if you have further questions you would like to pose to the council, I would be happy to take them back and we will get you an answer.

Chairman CONRAD. Thank you very much.

Mr. TILL. You are welcome, sir.

Chairman CONRAD. With that, we will close the hearing.

[Whereupon, at 12:27 p.m., the committee was adjourned.]

OPENING STATEMENT OF SENATOR TIM JOHNSON

Mr. Chairman, I am pleased that we are holding this hearing today to discuss the ramifications of the President's budget proposals on highway fuinding, education programs, and the Army Corps of Engineers.

I have strong concerns about the level of highway funding in the President's budget for fiscal year 2003. As we all know, TEA–21 was enacted to provide a guaranteed funding stream for highway projects throughout the Nation. Highway construction and improvements are funded through an excise tax on gasoline that goes directly into the highway fund. This arrangement guarantees that revenues raised are used only for road projects.

South Dakota and the Nation have greatly benefitted from this funding, which has resulted in new roads and improvements throughout my State. Because of the great distances in South Dakota, we are extremely dependent on surface transportation for economic development and travel. Without adequate roads and infrastructure, the economy of South Dakota and the State will suffer.

However, the President's budget for fiscal year 2003 contains an unexpected huge reduction on highway funding of $8.6 billion-a cut of over 25 percent. This will result in a loss of $53 million for South Dakota and potential disruptions in existing road projects. 7,500 people are employed in my State on road projects that are funded through the Highway Trust. The proposed reductions means 2000 jobs will be lost in the State this year alone. For a small-population State like South Dakota, this is a major job loss.

Moreover, there are 200 projects in South Dakota that are funded through the Highway Trust Fund. In addition, there is a $700 million backlog in projects in my State that will only get worse with severe reductions in resources.

This is unacceptable. The reduction is due to largely to technical corrections and overestimations of revenues in prior years. But it is under the amount that was guaranteed for this year under the 1998 Act. Technicalities should not result in I have co-sponsored a bill that would raise the amount allocated by $4.4 billion this year, about half of the proposed cut. While this is a good start, as a member of the Senate Budget and Appropriations Committees, I will work to see that the funding: is further raised to an amount comparable to last year's figures. We must ensure that our infrastructure is adequate for future needs and growth.

In addition, I am disappointed by the Administration's decision to not fund the Missouri River Restoration Act in the Army Corps budget. Although it is listed in the United States Army Corps of Engineers fiscal year 2003 budget at $750,000, it is my understanding a decision has been made to eliminate that funding. The Missouri River Restoration Act is designed to provide needed funds for improved conservation in the river's watershed, reduce sediment loads in the river, and extend the life of South Dakota's reservoirs. Under the Act, $50 million has been authorized over 5 years and it is my hope that the Administration will take an active role in helping fund this critically important measure. As a member of the Apporopriations Committee, I will to see that this the program is adequately funded this year.

I am concerned with funding level the Administration has provided for the Pierre/ Ft. Pierre buyout in South Dakota. This is an ongoing project to relocate homeowners who have been displaced because of flooding on the Missouri River. $10 million is needed this year to continue that process. Unfortunately, only $1.426 million is included in the budget and because of this very low figure, it will be much harder for Senator Daschle and I to bring that funding level up to where it needs to be. Last year, $6 million was appropriated and I will work to see that the funding is increased this year.

With respect to education, the passage of the recently-enacted. No Child Left Behind Act means States and local education agencies will now be equipped with new resources and guidelines for improving our education system and continuing our efforts to provide every child with the best education in the world. The new education bill also provides for new testing and accountability measures to be implemented by States and public schools. Therefore, it is critical that we provide sufficient education funding from the Federal level to allow our States and schools to meet these new testing and accountability mandates. Without adequate funding, we are simply setting up our schools for failure.

Along those lines, we must also preserve funding in the Fiscal Year 2003 budget for rural education initiatives. I am deeply concerned with the Administration's education budget which includes an elimination of funding for critically important rural education programs. Specifically, the Administration's budget eliminates funding for Rural Education Achievement Program (REAP) initiatives which were funded at $162.5 million for Fiscal Year 2002. Designed to help rural districts that lack the personnel and resources to compete effectively for Federal competitive grants and that receive grant allocations in amounts that are too small to be effective in meeting their intended purposes, these flexibility programs are vastly needed in rural school districts throughout States like South Dakota.

I am hopeful that the Chairman will share my concern on these issues and I look forward to working with the Committee to adequately these programs in the Fiscal Year 2003 Budget Resolution.

[The prepared statement of Senator Murray follows:]

THE PREPARED STATEMENT OF SENATOR PATTY MURRAY

Mr. Chairman, thank you for calling this hearing on two issues vital to the ongoing success of our Nation and the renewal of our economy—education and transportation. Last year the Congress passed and the President signed ESEA reauthorization.

The bill had two parts. On one hand, it called for higher standards and accountability. On the other hand, it promised more investments so schools could make progress. Just a few months later and already the President's budget has pulled the rug out from under our students by reneging on the promised investment. It cuts funds for teacher quality and class size reduction activities. It freezes funding for after school programs and Safe and Drug Free Schools. And it does not fully fund our share of special education costs, failing yet again to fulfill that commitment to our communities, our schools and our disabled students. We know what the needs are out there. We know what works to help our children succeed. Unfortunately, this budget does not do enough to help.

Education is not the only area where this budget falls short of meeting our country's needs. Mr. Chairman, our communities are working to strengthen their economy during the current recession. Unfortunately, many regions are being held back by outdated and inadequate infrastructure.

In my own State of Washington, we are experiencing a transportation crisis. We know that investing in our critical infrastructure will pay real dividends for our communities. Better roads and highways mean less time wasted in traffic, greater productivity, and a better quality of life. In addition, transportation projects create jobs and lay the foundation for our future economic growth. That's why I'm so disappointed that the President's budget cuts billions of dollars in infrastructure investments.

In fact, this $8.5 billion cut in 2003 is the single largest proposed cut across the entire government. Not only will it prevent us from improving our productivity, business climate and economic growth, it also threatens to eliminate over 350,000 jobs across the country.

Mr. Chairman, I want to insert into the record a list of what this cut means to the people of every State. Let me just summarize this chart with one statistic. Looking just at the States represented on this committee, our communities will lose more than 3 billion dollars in infrastructure investments.

When I asked the President's Budget Director about the cuts, Mitch Daniels said that the Administration was only following the requirements of the TEA–21 law. What Mr. Daniels failed to say is that—throughout his budget proposal—there are hundreds of examples where the Administration is asking us to ignore existing law or to change the law.

Just within the Transportation Budget, we are asked to ignore current law and to adopt measures to throw several communities out of the Essential Air Service program. We are asked to ignore the TEA–21 law and divert transit formula funds to the President's "New Freedom Initiative." We are asked to ignore current law and impose new user fees on railroads, shipping companies, and transporters of hazardous materials. We are also asked to ignore the TEA–2l law and lower the Federal cost share for major transit projects.

Simply put, the Administration wants to change the law dramatically in many areas, but uses the law as an excuse for cutting highway funding.

THE LONG-TERM BUDGETARY OUTLOOK

WEDNESDAY, FEBRUARY 27, 2002

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

The committee met, pursuant to notice, at 10:05 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad (chairman of the committee) presiding.

Present: Senators Conrad, Stabenow, Corzine, Domenici, and Snowe.

Staff present: Mary Ann Naylor, staff director; and Sue Nelson, deputy staff director.

For the minority: G. William Hoagland, staff director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. I will bring the committee to order.

There has been a vote scheduled for 10 or somewhat after that time, but we can anticipate a vote soon. But I wanted to begin with my statement and then defer to Senator Domenici, if he arrives. He may well be at the floor anticipating the vote right at 10 o'clock. If that occurs, Bill, will you just have him go ahead and reconvene us and assume the Chairmanship until I return. I would appreciate that.

First of all, I want to welcome Comptroller Walker to the panel. He has appeared here before. He is somebody that enjoys, I think on both sides of the aisle, strong credibility. I know I never fail to benefit from your thoughtful analysis, and we very much appreciate the thinking and the energy that you have put into helping us evaluate the long-term challenges that this country faces as we look to the future, understanding that what we are facing now is unlike anything we have ever seen before.

I think one of the problems Washington is having with this new fiscal environment is that it is substantially different than anything we have ever faced before. Always before, the following generation has been bigger than the one that was retiring, and that is about to change in a dramatic way. And it is very hard to fully understand how dramatic these changes are, and that is the reason we wanted to have this hearing today.

When you met with us last year, you advised that no one—and this is a quote—"No one should design tax or spending policy pegged to the precise numbers in any 10-year forecast." How I wish more people would have listened to your wise counsel then. We could have avoided perhaps some of the very serious fiscal problems we now confront.

They say bad news comes in threes, and I am afraid that may be the case when it comes to the budget outlook this year.

First we learned from CBO in January that the surpluses we worked so hard to achieve have all but disappeared. Last year, CBO projected there would be some $5.6 trillion in surpluses over the next 10 years. Twelve months later, CBO reported to us that the surplus for that same period had dropped by $4 trillion, and that projection does not count the President's defense buildup, his request for homeland security or an economic stimulus package. It also presumes that the tax cut sunsets in 2010 as required under current law.

The second piece of bad news came in the form of the 2003 budget submittal from the President, which reduced the $1.6 trillion remaining surplus even further, reducing it by another approximately $1 trillion. And I suspect that when CBO does their re-estimates of the President's budget that they will tell us the circumstance is even worse than that.

Under the plan proposed by the President, we return to non-trust fund deficits for as far as the eye can see. These are CBO's numbers, and they show non-trust fund deficits for the entire next decade.

And I don't expect your news to be particularly good either, although we certainly can't blame the messenger. Since you did your level best to warn us about overcommitting the surplus last year, I expect to hear from you that the tax cut, the recession, and the attack of September 11th have taken their toll on the long-term budget outlook as well as on the short-term projections, making the task of addressing our long-term needs even more difficult.

The hard reality is that last year we were told that the non-trust fund surpluses over the next decade would be $2.7 trillion. And now we are told the non-trust funds can anticipate a $2.2 trillion deficit. Of course, where does that money come from? It comes out of the trust funds of Medicare and Social Security. There is no alternative but for that to be the case.

The decisions that were made last year and the current state of the budget have enormous implications for our long-term fiscal future. Really, that is the message of this hearing.

In your testimony last year, you advocated growing the economy through increased national savings and principally through running surpluses to pay down debt. Reducing deficits and running surpluses has propped up a steady decline in personal savings which stood in the year 2000 at seven-tenths of 1 percent.

In the United States, net national savings has risen substantially over the past 7 years, from 3.3 percent of GDP in 1993 to 5.5 percent in 2000. But the improvement in Federal savings more than explains the entire improvement in national savings. In other words, it is because the Federal Government has been running surpluses that our rate of national savings has increased.

Personal savings has been going down. National savings we got going up, and we got it going up by the Federal Government running budget surpluses.

Why is national savings important? National savings is important because that is the pool of money that is available for investment. And it is investment which makes us able to grow the economy. It is these connections that are critically important.

You know, I think sometimes that when those of us who have talked for a long time about the need to be fiscally responsible and the need to run budget surpluses, especially in light of the baby boomers about to retire, I think some people in the public say, well, that a bunch of green-eyeshade guys who are worried about accounting and they are worried about things adding up.

Well, that is important, but that is not the real importance of the exercise. The real importance of the exercise is having economic growth in the future so that America can meet its long-term obligations.

Some say, well, you don't have to worry about it. The money is being credited to the Social Security Trust Funds. And that is true. The money is credited to the trust funds when it comes in in the payroll taxes. And then we have a special certificate, a treasury bond, if you will, that is in the trust funds. But there is no money there and those obligations are going to have to be redeemed in the future out of the revenue stream of the Federal Government.

Of course, we know the Federal Government has never reneged on its obligations. But that doesn't reduce the hard reality that a future Congress and a future President are going to face very difficult choices.

I am also very concerned that the dramatic decline in surplus resources leaves us little room to address the solvency of the Social Security Trust Funds. The President has put forth a budget that spends the Social Security surpluses in each year over the next decade. Further, his budget fails to account for the substantial implementation resources, some $1 trillion, according to Social Security actuaries, required for his Reform Commission Social Security private accounts plans. Each of the recommendations of his commission will cause significantly higher deficits than the President's budget currently acknowledges.

You know, a number of weeks ago I said this reminded me of Enron accounting. And I did it because on the way in that morning I heard a description of what got Enron in trouble, and what caused the problem for Enron was that it was hiding its debt—hiding its debt from its creditors, hiding its debt from its investors, perhaps even hiding its debt from themselves.

I am very concerned that the Federal Government is on that same path, that we are understating our long-term obligations, that we are, in effect, fooling the American people, I think even fooling ourselves.

This talk of surpluses to me is totally misleading. There are no surpluses. All the money is fully committed—in fact, it is overcommitted. And unless we face up to that reality, I am very concerned about what a future Congress and a future President will find when they go to the cupboard and the cupboard is bare.

All of this has been made more complicated by the tax cut passed last year, by the economic recession, and by the attack of September 11th. But we are going to have to face up to this as a society. Putting our heads in the sand, making believe that it is not there, making believe that these debts are not going to come true is not going to solve the problem.

So I hope very much that today, General Walker, you will give us the longer-term outlook, where we are headed as a country, and help us to understand how that fits in with our current budget deliberations.

The vote is now occurring on the Senate floor. There are about 5 minutes left. So I will recess the Committee and return. Again, I would ask that if Senator Domenici gets here before I return that he reopen the Committee and make his statement, and then we have an opportunity to hear from General Walker. I would ask that we wait until I return for Mr. Walker to begin his statement, if we could. [Recess.]

Senator DOMENICI. I ran into the Chairman en route. He suggested that I open the meeting and proceed with my opening remarks. He said he would be back soon, perhaps about the time I am finished. I had planned to yield to you, Senator, if you had some opening remarks, as soon as I am finished here.

Senator CORZINE. Thank you.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. First of all, I want to say thank you to you again for joining us. I note that the title of this hearing is long-term budgetary issues, and I appreciate hearing GAO's assessment of the long term.

I do, however, want to be honest and say I suspect that it is not very different from what we have known for a decade, and you have presented the evidence that you are going to present in a slightly different way to us heretofore, indicating the demographics that confront this country with reference to the future.

When we look out 20, 30, even 40 years from now, the pressure from the demographic changes, especially of the baby-boom generation, will strain this Government if nothing is done to reform Social Security or Medicare. And I understand you told us that the last time you were here, and we had a little discussion about what it meant to reform them. Of course, in your position you were not talking about detailed reform within the programs but, rather, generally giving us some of your thoughts, which were very helpful.

But the story isn't new. There have been three commissions over the past decade whose missions have been to address long-term fiscal issues, and I assume that you and your people, as good as they are, have looked at all those and that the conclusions and the good thoughts have been incorporated in your discussion here today.

There was one commission on Entitlement Reform. I think we all remember it. It was led by Kerrey and Danforth. They were put on that to chair that with people having great enthusiasm that there would be major changes. Then there was the commission on the Future of Medicare, led by Senator Breaux and Representative Thomas, and then President Bush's commission to Strengthen Social Security. I see that all these reports contained information that is being summarized by you, Mr. Walker, and in a sense, given kind of a unity of understanding.

This Senator has always approached fiscal policy from a balanced viewpoint. Do what is best for the economy and the American people, both in the short term and the long term. That is getting more and more difficult to do. There is no question about it.

I believe the action we took last year to reduce the tax burden on Americans was best in the short and in the long term. A large majority of my colleagues agreed, as did Chairman Greenspan and other students of fiscal policy.

Tomorrow, I believe that we are going to receive yet more evidence that the recession was shallow, perhaps the shallowest in history. I don't know whether you, Mr. Walker, have commented on it in your remarks. I did not get a chance to read them. But it seems pretty obvious that the recession is going to be rather shallow.

In fact, many economists expect that we grew at about a positive 1 percent rate in the fourth quarter. This means that we only had one quarter of negative growth and the overall growth rate during the recession was about zero rather than being negative. That is good. That is good news for future Social Security recipients, too.

In my view, one of the key reasons the recession was as shallow as it was was because the tax cut came in just at the right time. We were out there saying we needed to reduce taxes, which was an important issue, and at the same time it seems like the first cut came in right when the recession might have bottomed, along with Alan Greenspan's and his Federal Reserve reduction in interest rates I think kept this economy from going into deeper recession.

Last year, I was concerned that we were on track, reducing our debts very rapidly, and then the rapidity with which we began to reduce our national debt caused me some concern. I don't have to repeat that concern now because obviously we don't have staring us in the face the huge surplus that concerned this Senator and others with reference to what would that money be used for.

I agree with the Director of the Congressional Budget Office who is fond of saying, and I quote, "It is not the size of the trust fund that matters, but the size of the economy." I would like to repeat that: "It is not the size of the trust fund that matters, but the size of the economy."

Finally, Mr. Walker, at this time last year, GAO issued an extensive series of reports on the high-risk areas of the Federal Government. Those reports as well as the work that Director Daniels and the OMB staff are doing will be extremely helpful in terms of the short-run focus of policymakers. I commend you for those reports. I think they are very good.

There is inefficiency in this Government that must be addressed, and we can never let up. We have to take a shot at that regularly as policymakers, or inefficiency will grow and will be much bigger than anybody assumes. Maybe you can help us determine where the American people are not receiving their money's worth. I think you are uniquely equipped to do that.

Now I wonder if the Chairman wants to proceed or does he want to wait. Does anyone know? [Pause.]

Senator DOMENICI. OK, Senator, you are in charge.

Senator CORZINE. Not with you around, Senator Domenici, I assure you.

I didn't prepare a formal statement, but let me just say for the record that I think nothing is more important than sorting out this balance between those short-term realities that we must face as public officials and the needs of the economy and our long-term fiscal stability, which will be upon us soon. The topic of this demographic bubble and its implications for medical care for Americans, not only the seniors but for all of Americans, along with the Social Security program is one that I think is as close to an honest dilemma that we face in our political life. And so resolving that and solutions to that, Mr. Walker, are ones that I am anxious to hear your thoughts about because we need to truly acknowledge that we are running into a Box Canyon on our fiscal affairs in this Nation. And I think we have a structure that doesn't provide solution for those.

I appreciate your commentary on it. It will be interesting to see how we can both finance Medicare, Medicaid, and our Social Security obligations and still perform the other functions of Government. And my fear is that we have prescribed a fiscal situation that reduces the role that Government plays to a level that is not acceptable to the American people on a whole host of other areas, including education and transportation infrastructure, et cetera.

I will stop here. The Chairman will be returning, but I look forward to your comments. I appreciate your straightforwardness and integrity on a whole host of issues in the reports that you have published in history.

Thank you.

Mr. WALKER. Thank you, Senator. [Pause.]

Senator CORZINE. Being a freshman Senator, I am learning how this works. Go ahead, Mr. Walker, and start your testimony. I think the Chairman should be here in a very few minutes.

STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

Mr. WALKER. Thank you, Senator. I am pleased to return this year to present GAO's perspective on the long-range fiscal policy challenges facing the Congress and our Nation.

Thank you, Mr. Chairman. I am just on the second sentence, so your timing is impeccable.

We meet today in a situation that seems very different from that of last February. Today the challenges of combating terrorism and ensuring our homeland security have come to the fore as urgent claims on our attention and on the Federal budget. While there are indications that the economic recovery is underway, the recession that began last spring, according to the National Bureau of Economic Research, has had real consequences for the budget.

These are important changes in the past year. At the same time, the known fiscal pressures created by the retirement of the baby-boom generation and rising health care costs remain the same this year as they have been for a number of years.

Absent substantive reform of entitlement programs, the rapid escalation of Federal spending for Social Security, Medicare, and Medicaid beginning less than 10 years from now is virtually certain to overwhelm the rest of the Federal budget. Indeed, the slowing economy and tax and spending decisions that were made during the past year, including increased spending levels necessary to respond to the new security challenges that we face, have increased these pressures on the budget. Correspondingly, the ultimate task of addressing these needs without unduly exacerbating the long-range fiscal challenge has become more difficult.

In summary, I would like to make the following points, and I have a few charts to illustrate a few of these points.

The surpluses that this committee and many others worked to achieve, with the help of the economy, not only strengthened the economy for the longer term and helped us in our fiscal posture for the longer term, but also put us in a stronger position to respond to the events of September 11th and to the economic slowdown than otherwise would have been the case.

Going forward, the Nation's commitment to surpluses will be severely tested. A return to surplus will require sustained discipline and very difficult choices.

Because the longer-term outlook is driven in large part by known demographic trends, in some ways we can be surer about the outlook 20 years from now than about the forecast for the next few years.

The message of GAO's updated simulations remains the same as last year: absent structural changes in entitlement programs for the elderly, in the long term persistent deficits and escalating debt will overwhelm the Federal budget.

Both longer-term pressures and new commitments undertaken after September 11th sharpen the need to look at competing claims and new priorities. A fundamental review, reassessment, and reprioritization of existing programs and activities is necessary both to increase fiscal flexibility and to make today's Federal Government fit the modern world. Stated differently, there is a need to engage in a fundamental reassessment of what is the proper role for the Federal Government in the 21st century and how should the Government do business in the 21st century.

This committee in the past—in particular, I know, Senator Domenici among others—has been very interested in trying to understand what works and what doesn't work within the base of Government. It is critically important that we get back to that. The fact of the matter is the numbers do not add up. We are not going to be able to sustain all the programs abd activities that we have now under current tax levels and projected tax levels; we would not be able to do it with huge increases in taxation—which I don't think would be acceptable or desirable—unless we end up dealing with some of these structural problems. That means we need to look at what exists today and ask whether or not it is still relevant in the 21st century; and if it is relevant in the 21st century, at what level of priority? Because there are new claims and competing needs before us. Look just at the health care area, where we already have a huge imbalance. There is increasing interest in having a prescription drug benefit, but at the same time we already have trillions of unfunded promises associated just Part A of Medicare alone, and prescription drugs represents the fastest-growing cost in health care.

The fiscal benchmarks and rules that moved us from deficit to surplus expire this year. Any successor system should facilitate both a debate about reprioritization of today's programs and spending and a better understanding of the long-term implications of current actions. Simply stated, there are many things that we may be able to afford to do today but we may not be able to sustain in the future.

If I may, let me show you three charts that illustrate this. Now, these are simulations. These are not projections. It is difficult enough to go out 10 years, Mr. Chairman, as you noted. You can't have a great degree of precision.

On the other hand, there is a higher degree of certainty with regard to demographic trends, because most of those persons are alive today. We can't be as certain about economic growth, but about demographics there is less doubt.

We show three different fiscal scenarios here. First, we show "the baseline extended", and you and others have articulated what the limitations of that scenario are. Second, we show the path where the Social Security surplus is saved after we come back to where we are not using part of that for other spending, which starts in about 2010. Finally, we show a path in which increasing discretionary spending increases at the rate of the economy, which is historically what has happened in recent years, and the tax cut is extended. That is both growing spending at about the rate that it has been growing for a number of years and extending the tax cuts beyond the scheduled sunset dates.

We do not endorse any of these. We are is not intending to take a position one way or another. These are three separate fiscal simulations. The bottom line is it is bad under any one of the three.

There is a difference as to the timing. There is a difference as to the magnitude of the challenge. But the challenge exists, and the challenge is worse today than it was a year ago when I was here.

The next chart——

Chairman CONRAD. Could I just stop you?

Mr. WALKER. Yes, sir.

Chairman CONRAD. Just before you take that down, let's, if we can, quantify how bad this gets, because under any of these scenarios, you are approaching deficits of 20 percent of GDP. Is that correct?

Mr. WALKER. That is correct. It is just a matter of when——

Chairman CONRAD. Twenty percent of gross domestic product as deficit. That would be—if we were to apply that today, try to put it in today's terms, that would mean $2 trillion of deficits. Is that correct?

Mr. WALKER. That is about right, roughly correct.

Chairman CONRAD. Yes.

Mr. WALKER. Today's dollars.

Chairman CONRAD. I hope people just stop and think about that. The whole budget today is $2 trillion. If we were to fast forward what your simulations are showing, we would be running $2 trillion deficits.

Mr. WALKER. At some point in time in the future.

Chairman CONRAD. At some point in time in the future, but that is applying the size of the economy today to the level of deficit you have in the future applied to the size of the economy today.

Mr. WALKER. Correct. Now, obviously the economy will be bigger in the future, so it will be 20 percent of the future——

Chairman CONRAD. Of an even bigger number.

Mr. WALKER. Correct.

Chairman CONRAD. But if you were to apply this 20 percent to today's economy, you would have a $2 trillion deficit today. We have a $10 trillion economy, 20 percent of GDP, you would have a $2 trillion deficit. I hope people are getting this. This isn't just a little bitty problem. This is a huge problem.

Mr. WALKER. And it has existed, as Senator Domenici said earlier, for a number of years. My concern is it may not be new news, but we have got to figure out how we are going to get on dealing with this, because it is not going away. Another concern that I have is that there are many activities or programs people want in theory today on Congress may need to act, and which may be affordable today. The question is will we be able to afford and sustain these actuaries in the future?

I agree with Director Crippen, and I have said similar things, that in the end it is not the size of the trust fund, it is the size of the economy.

All of these simulations are based upon CBO assumptions. We are not going to compete with our sister agency on that. We use their economic growth path. Obviously, if economic growth, is greater it will make it better. The scenario won't be as bad. But I would respectfully suggest the situation is so serious that you are not going to grow your way out of this problem. As a result, the Congress needs to figure out—we need to figure out—as a Nation—how best to go about addressing this challenge.

If I can show the next one, Mr. Chairman, I think it illustrates this even better. Again, we take current law as a starting point—not a policy or position but a basis for the simulation.

The line shows taxes as a percentage of GDP. The scenario uses CBO assumptions, and the Social Security and Medicare trustees' best estimate assumption of what is likely to happen on spending for those programs in the future. Finally, this scenario assumes that discretionary spending grows at the rate of the economy, and the provisions in the 2001 tax bill don't sunset——

Between 2000 and 2030 you get to the point where you either have to cut all other spending by a little more than two-thirds, or you have to increase taxes by about 35 percent, or some combination of the two. Neither one of these is desirable.

Chairman CONRAD. Why don't you just repeat that so that this sinks in.

Mr. WALKER. Under this scenario, it would say that by the year 2030—and, of course, you would have to do it before that. This is a point in time. Overall tax levels at the Federal level would either have to increase by about 35 percent, or all other spending would have to be cut by a little more than two-thirds.

Now, as you know, Senators, discretionary spending includes things like national defense, homeland security, the judicial system of the Nation, education programs, infrastructure spending. Some of these are in the Constitution of the United States and obviously cannot be compromised in any way. This is just to illustrate the magnitude of the problem.

By the time you get to 2050, there is only enough money to pay interest on what will be a massive Federal debt that will have been reaccumulated and Social Security, basically. The alternative would be to double Federal taxes.

Chairman CONRAD. Let's rivet on that point: 2050, the only things you could pay for would be the interest on the debt and Social Security. You wouldn't be able to pay—you wouldn't have any money for Medicare. You wouldn't have any money for any other discretionary spending.

Mr. WALKER. That is correct, under this simulation.

Now, let's face it. If you go out 50 years, God only knows what is going to happen 50 years from now. But point is this: Not to be as precise, but to show the magnitude of the gap, the gap is huge. And as I said before, yes, we can ease the pressure if we can grow the economy at a faster rate. But I would respectfully suggest you are not going to grow your way out of this problem.

And I would also respectfully suggest the Congress is probably not going to want to increase taxes to this level, nor is it going to want to decrease all other spending by this much. This is all the more reason why we have got to figure out how can we go about establishing, metrics and processes to begin to address these situations while we have more flexibility and while people have time to be able to adjust to whatever changes might be made.

Chairman CONRAD. Let me just stop you on that point. In 2050, you would have to eliminate all domestic spending, all spending for defense, all Medicare spending, all spending on law enforcement, judiciary, every Government agency, because the only money you would have is money to pay for Social Security and interest on the debt, or an 100 percent increase in taxes.

Mr. WALKER. Federal taxes.

Chairman CONRAD. Yes, Federal taxes. A 100 percent increase in taxes. Now, let me ask you one other question. People will say, 2050, what are they talking about? But let's understand what the assumptions are. The assumptions are just current law. You are not up here making up new law.

Mr. WALKER. It is not current law, in fairness. There are two adjustments to current law here.

Chairman CONRAD. And what are those?

Mr. WALKER. The two adjustments to current law are: No. 1, you are growing discretionary spending at the rate of the economy, which historically over the last——

Chairman CONRAD. So you are taking current law as the base.

Mr. WALKER. Right.

Chairman CONRAD. And then you are adding an inflationary adjustment.

Mr. WALKER. More the inflation. It is growing at the rate of the economy rather than inflation.

Chairman CONRAD. The economy.

Mr. WALKER. Which is generally——

Chairman CONRAD. Which is basically what has been happening.

Mr. WALKER. Which is basically what has been happening up through last year, and——

Chairman CONRAD. And the tax cuts do not sunset.

Mr. WALKER. Right, correct. It assumes that Congress—and I am not saying that is good, bad, or indifferent, either one. It is a scenario. We have two other scenarios. You know, we have two other scenarios that have somewhat more favorable outcomes than this, but I would respectfully suggest nonetheless unacceptable outcomes, even though they are somewhat more favorable than this.

As Senator Domenici said before, this is really not new. I mean, we have faced this scenario, as you know, Mr. Chairman, we have faced this scenario to differing degrees ever since GAO started doing the simulations 10 years ago. And if I could——

Chairman CONRAD. Has it gotten better or worse?

Mr. WALKER. It depends on which year you are talking about. Some years it got better, some years it got worse, the bottom line is we have always had a big problem.

Senator CORZINE. Mr. Chairman, may I ask, in the last year has it gotten better or worse?

Mr. WALKER. Well, it has gotten worse, but it has gotten worse for a number of different reasons. You know, some of it had to do with the economy. Some of it had to do with increased spending. Some of it had to do with changes on the revenue side. So it has been a lot of different reasons why it has gotten worse. No one single reason.

Senator STABENOW. Mr. Chairman, if I might also just ask a question as well, did you look at what would happen if, in fact, the tax cuts were accelerated so that they would be fully in effect in the next couple of years?

Mr. WALKER. Senator, we did not. I have a difficult position here, and that is, what I am trying to do is I am trying to provide meaningful information that is policy neutral, because I don't think it is GAO's job nor my job as Comptroller General to say it is a good idea or a bad idea to do X or Y on taxes or on spending. I do think, however, it is my responsibility as the chief accountability officer to be able to show you what the future might look like and to try to help people understand that we need to be thinking about some of these things when the Congress is making decisions today, whether it be on the tax side or the spending side or whatever.

Chairman CONRAD. I think your statement earlier was about as clear as it can be. This whole thing doesn't add up.

Mr. WALKER. The numbers don't add up.

Chairman CONRAD. They don't add up. All right.

Mr. WALKER. Let me wrap it, Mr. Chairman. The next one just illustrates something that I think, again, hasn't changed much from last year, but we just need to get on with dealing with it, quite frankly. That is, these are the negative cash-flows that start in 2016 for Social Security and Medicare, and you see how rapidly they escalate.

I was a trustee of Social Security and Medicare for 5 years, from 1990 to 1995. Trust fund solvency matters, but it can be misleading. What is more important is how big are these programs as a percentage of the economy, how big are they as a percentage of the budget, and are they sustainable. In addition, cash-flow is important, and we turn negative cash-flow in 2016. This is just a subset of the problem, if you will.

So, in summary, Congress and the President stand at a point where current needs and wants need to be balanced against known long-term pressures. As stewards of our Nation's future, we need to begin to prepare for tomorrow. In this regard, we need to start focusing on how best to go about addressing these structural challenges in a reasonably timely manner in order to identify specific actions that need to be taken in order to avoid this train wreck in the future.

This will not be easy. But it is not going to get any easier the more we wait. And obviously GAO stands ready, whether it is through our high-risk work or whatever else that we have done, to try to help the Congress in answering those two key questions that I mentioned before which are critically important. What is the proper role for the Federal Government in the 21st century? And how should the Federal Government do business? Reviewing, reassessing, reprioritizing existing Federal programs and policies.

Mr. Chairman, I would respectfully suggest that this committee combined with the Governmental Affairs Committee are in a perfect position to be able to take a leadership role in trying to address those two fundamental questions. What is the proper role? And how should the Government do business? And we stand ready to assist you.

[The prepared statement of Mr. Walker follows:]

THE PREPARED STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

Chairman Conrad, Ranking Member Domenici, and Members of the Committee:

I am pleased to return this year to present GAO's perspective on the long-range fiscal policy challenges facing this Congress and our Nation. We meet today in a situation that seems very different from that of last February. Today the challenges of combating terrorism and ensuring our homeland security have come to the fore as urgent claims on our attention and on the Federal budget. While there are indications that an economic recovery is underway, the recession that began last spring has had real consequences for the budget. These are important changes in the last year. At the same time, the known fiscal pressures created by the retirement of the baby boom generation and rising health care costs remain the same. Absent substantive reform of the entitlement programs, a rapid escalation of Federal spending for Social Security, Medicare, and Medicaid beginning less than 10 years from now is virtually certain to overwhelm the rest of the Federal budget. Indeed, the slowing economy and tax and spending decisions, including the increased spending levels necessary to respond to new security challenges, have increased pressures on the budget. Correspondingly, the ultimate task of addressing these needs without unduly exacerbating the long-range fiscal challenge has become much more difficult. In my testimony today I make the following points:

- The surpluses that many worked hard to achieve—with help from the economy—not only strengthened the economy for the longer term but also put us in a stronger position to respond to the events of September 11 and to the economic slowdown than would otherwise have been the case.
- Going forward, the Nation's commitment to surpluses will be tested: a return to surplus will require sustained discipline and difficult choices.
- Because the longer-term outlook is driven in large part by known demographic trends, in some ways we can be surer about the outlook 20 years from now than the forecast for the next few years.
- The message of GAO's updated simulations remains the same as last year: absent structural changes in entitlement programs for the elderly, in the long term persistent deficits and escalating debt will overwhelm the budget.
- Both longer-term pressures and the new commitments undertaken after September 11 sharpen the need to look at competing claims and new priorities. A fundamental review of existing programs and activities is necessary both to increase fiscal flexibility and to make government fit the modern world. Stated differently, there is a need to consider what is the proper role of the Federal Government in the 21st century and how should the government do business in the future.
- The fiscal benchmarks and rules that moved us from deficit to surplus expire this fiscal year. Any successor system should facilitate both a debate about reprioritization today and a better understanding of the long-term implications of different policy choices. Simply stated, there are many things that we may be able to afford to do today but we may not be able to sustain in the future.

The Fiscal Backdrop for Today's Choices

Today it is evident that recent surpluses were the result not only of hard choices made earlier in the 1990's, but also of fortuitous economic, demographic, and policy trends that are no longer working for us as we enter the 21st century. In retrospect, the Nation emerged from deficits of nearly three decades only to find itself in what has been called "the eye of the storm." The passage to surpluses was aided by a tailwind consisting of (1) extraordinarily strong economic growth, (2) a slowing of health care cost growth, (3) a demographic holiday stemming from low birth rates during the Depression and World War II paired with a large workforce resulting from the post-war baby boom—which together gave rise to a stable worker-to-beneficiary ratio in Social Security, and (4) the fall of the Soviet Union permitting a decline in defense spending as a share of the economy.

The fiscal winds have now shifted—many of these fortunate trends have now reversed course and are making the choices harder. Although it appears the economy may have turned the corner, forecasters are not showing a return to the extremely rapid growth the Nation enjoyed during the last half of the nineties. Health care costs have once again resumed growing at double-digit rates. Reductions in defense spending can no longer be used as a means to help fund other claims on the budget; indeed, spending on defense and homeland security will grow as we seek to defeat terrorism worldwide. Finally—and I know this is one of the reasons you invited me here today—the Nation's demographic holiday is ending. In 2008—only 6 years from now—demographic storm clouds will begin to shadow the baseline as the first wave of baby boomers become eligible to claim Social Security.

However one allocates credit across the events and decisions that led to years of surpluses, we benefited from that achievement. These large surpluses not only helped in the short term by reducing debt and interest costs but also strengthened the budget and the economy for the longer term. The budgetary surpluses of recent years put us in a stronger position to respond both to the events of September 11 and to the economic slowdown than would otherwise have been the case.

However, going forward, the Nation's commitment to surpluses will truly be tested. For the last few years surpluses were built in to the baseline so that given a lack of policy action, there would be a surplus. Last year, the Congressional Budget Office (CBO) baseline not only projected unified surpluses for at least the 10-year window but also substantial surpluses in the non-Social Security portion of the budget. Saving the Social Security surplus became an achievable and compelling fiscal policy goal for the Nation in this context. This is no longer true. At least for the next several years the baseline does not turn to unified surplus. A surplus in the non-Social Security portion of the budget is not projected under the baseline to emerge until 2010. As a result, explicit policy actions on spending and/or revenue will be necessary to return to and maintain surpluses over the next 10 years.

The Known Demographic Challenge

Although in important ways you begin the task of crafting a budget this year in a very different place than you did last year, in other ways the responsibilities remain the same. We still have a stewardship obligation to future generations. By stewardship obligation I mean that in making budget decisions today, it is important to be mindful of their impact on the future. This means that in responding to the legitimate needs of today, we should take into account the longer-term fiscal pressures we face. The message of GAO's long-term simulations, updated using CBO's new budget estimates, is consistent with previous simulations: absent change, spending for Federal health and retirement programs eventually overwhelms all other Federal spending.

As we look ahead we face an unprecedented demographic challenge. A Nation that has prided itself on its youth will become older. Between now and 2035, the number of people who are 65 or over will double. As the share of the population over 65 climbs, Federal spending on the elderly will absorb larger and ultimately unsustainable shares of the Federal budget. Federal health and retirement spending are expected to surge as people live longer and spend more time in retirement. In addition, advances in medical technology are likely to keep pushing up the cost of providing health care. Moreover, the baby boomers will have left behind fewer workers to support them in retirement, prompting a slower rate of economic growth from which to finance these higher costs. Absent substantive change in related entitlement programs, large deficits return, requiring a combination of unprecedented spending cuts in other areas, and/or unprecedented tax increases, and/or substantially increased borrowing from the public (or correspondingly less debt reduction than would otherwise have been the case). These trends have widespread implications for our society, our culture, our economy, and—of most relevance here—our budget.

Ultimately, as this Committee and its counterpart in the House recommended on October 4,[1] 1 the Federal Government should attempt to return to a position of surplus as the economy returns to a higher growth path. Returning to surpluses will take place against the backdrop of greater competition of claims within the budget. Although budget balance may have been the desired fiscal position in the past decade, surpluses would promote the level of savings and investment necessary to help future generations better afford the commitments of an aging society.

Early action is important. We all recognize that we have urgent matters to address as a Nation and our history shows we have been willing to run deficits during wars and recessions. However, it remains important that to get on with the task of addressing the long-term pressures sooner rather than later. Some will suggest that early action may not be necessary—for example, that faster economic growth may enable a smaller pool of workers to more easily finance the baby boom retirement. While this might happen, the best estimates of the actuaries suggest it is unlikely. CBO has also said that the Nation's long-term fiscal outlook will largely be determined by Federal spending for retirees, especially for health.

Although long-term projections are inherently more uncertain than short-term forecasts, in some ways we can be surer about the outlook 20 years from now since it is driven by known demographics. The swing in 1-, 5-, and 10-year projections over the last 12 months has served to emphasize the extent to which short-term projections are subject to uncertainty. And CBO notes that this year the near-term projections are subject to unusual uncertainties as the Nation wages war on terrorism and recovers from a recession. CBO pointed out that it is considered more difficult to forecast the economy when it is entering or exiting a recession. This year there are additional uncertainties in the near-term budget outlook. CBO's reference case—the baseline—from which you begin your deliberations (and which in the first 10 years is the underpinning for our long-term model) is a representation of current laws and policies. Thus, by definition it does not account for the effects of future legislation, including likely increases in spending for defense and homeland security to which both parties have agreed in principle. Nor, as CBO noted, does it make assumptions about a number of issues, e.g., the extension of agriculture programs, Medicare prescription drug coverage, changes in the Alternative Minimum Tax, or the extension of various expiring tax provisions.

Given this extreme uncertainty around the next 1 to 5 years, why look out 20 or 30 years? Absent some draconian or unexpected dramatic event, the long-term budget outlook is driven by factors already in motion—most notably the aging of the population. In previous testimonies before you, I have talked about a demographic tidal wave, Beginning about 2010, the share of the population that is age 65 or older will begin to climb, surpassing 20 percent by 2035. (See fig. 1.)

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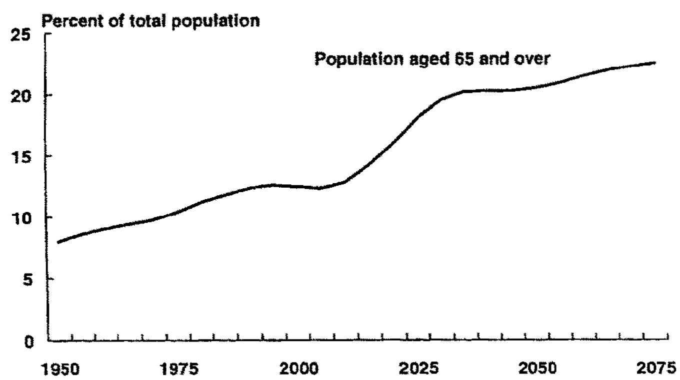
[1] House and Senate Budget Committees, The Revised Budgetary Outlook and Principles for Economic Stimulus (Oct. 4, 2001).

Figure 1: Aged Population as a Share of Total U.S. Population Continues to Grow



Note: Projections based on intermediate assumptions of the 2001 Trustees' reports.
Source: *The 2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

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Source: *The 2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

GAO's Model Simulations Illustrate Long-term Budget Challenges

Because of the coming demographic shift, the message from our simulations remains the same as last year, indeed as since we first published results from our long-term model in 1992: Absent policy change, in the long term, persistent deficits and escalating debt driven by entitlement spending will overwhelm the budget. This year we ran three different policy paths to illustrate the implications of a range of budgetary choices. I'd like to emphasize again that these simulations are not intended to endorse a particular policy but rather to illustrate the long-term implications of different scenarios.

All three scenarios begin with CBO's baseline estimates. The first starts with the baseline where for the first 10 years tax and entitlement laws are unchanged—including sunset provisions—and discretionary spending grows with inflation. After the first 10 years, we hold discretionary spending and revenues constant as a share of gross domestic product (GDP) and allow Social Security and Medicare to grow based on the actuaries' intermediate estimates.[2] In this path, the unified surpluses that emerge in 2004 are saved. Nevertheless, deficits return in 2036. At the other end is an alternative policy path in which discretionary spending grows with the economy in the first 10 years and in which last year's tax cuts are extended. This yields a smaller period of surpluses with deficits returning in 2011. In both of these paths taxes remain constant as a share of GDP after 2012; this is, of course, a policy decision. To illustrate something in between these two paths, we simulated a third that tracks the CBO baseline until 2010. After 2010 we assume that the full Social Security surplus is saved through 2024[3]—this requires some combination of tax and spending policy actions. In this simulation deficits reemerge in 2025. (See fig. 2.)

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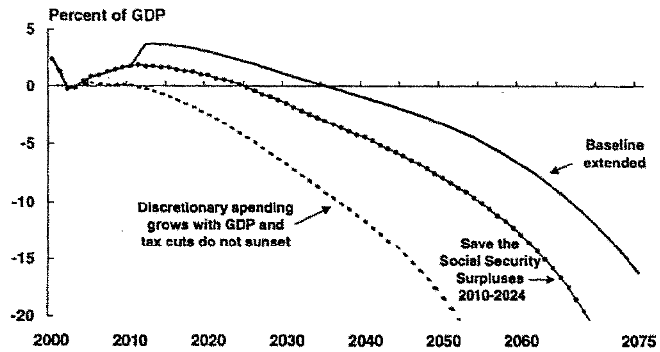
[2] We also assume that all current-law benefits in entitlement programs are paid in full (i.e., we assume that all promised Social Security and Medicare benefits are paid including after the projected exhaustion of the respective trust funds).

[3] The last year of projected Social Security surpluses (including interest income) under the 2001 trustees' intermediate estimates. As discussed later in this testimony, program expenses exceed non-interest income beginning in 2016.

Figure 2: Unified Surpluses and Deficits as a Share of GDP Under Alternative Fiscal Policy Simulations



Source: GAO's January 2002 analysis.

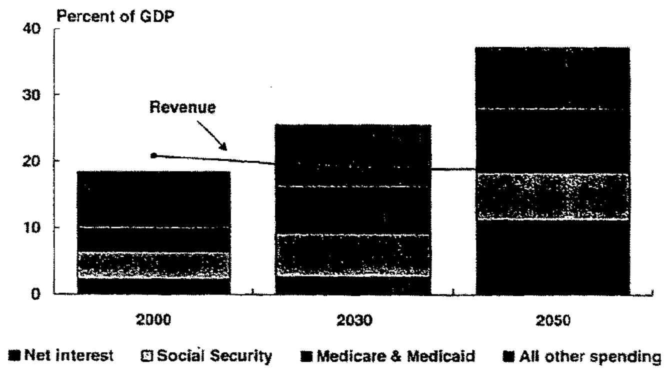
Source: GAO's January 2002 analysis.

In all three paths, surpluses eventually give way to large and persistent deficits. These simulations show that there is a benefit to fiscal discipline—it delays the return to deficits—but that even the most demanding path we simulated—a path that does not provide for funding Presidential or many Congressional initiatives—is structurally imbalanced over the long term. Although savings from higher surpluses are important, they must be coupled with action to slow the long-term drivers of projected deficits, i.e. Social Security and health programs. Surpluses can help—they could, for example, facilitate the needed reforms by providing resources to ease transition costs—but, by themselves, surpluses will not be sufficient.

In the long term, under all three paths Federal budgetary flexibility becomes increasingly constrained and eventually disappears. To move into the future with no changes in Federal health and retirement programs is to envision a very different role for the Federal Government. Assuming, for example, that last year's tax reductions are made permanent and discretionary spending keeps pace with the economy, spending for net interest, Social Security, Medicare, and Medicaid consumes nearly three-quarters of Federal revenue by 2030, leaving little room for other Federal priorities including defense and education. By 2050, total Federal revenue is insufficient to fund entitlement spending and interest payments—and deficits are escalating out of control.[4] (See fig. 3.)

[4] Due to recent changes in methodology as well as updates to underlying assumptions, simulations presented in this testimony are not comparable to previously published simulations.

Figure 3: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP and the Tax Cuts Do Not Sunset



Source: GAO's January 2002 analysis.

Source: GAO's January 2002 analysis.

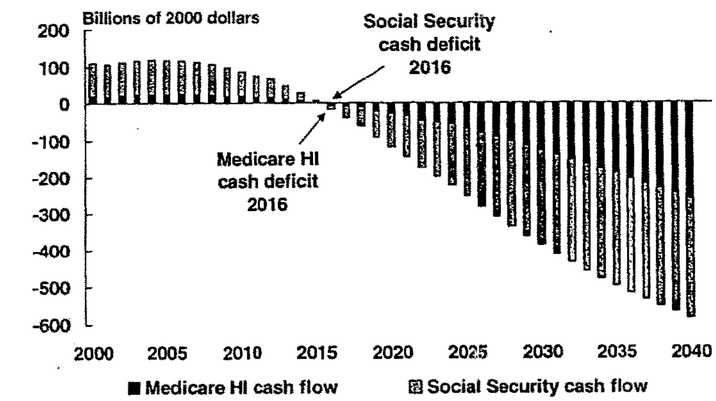
Reducing the relative future burdens of Social Security and Federal health programs is critical to promoting a sustainable budget policy for the longer term. Absent reform, the impact of Federal health and retirement programs on budget choices will be felt as the baby boom generation begins to retire. While much of the public debate concerning the Social Security and Medicare programs focuses on trust fund balances—that is on the programs' solvency—the larger issue concerns sustainability.

The 2001 Trustees Reports estimate that the Old-Age Survivors Insurance and Disability Insurance (OASDI) Trust Funds will remain solvent through 2038 and the Hospital Insurance (HI) Trust Fund through 2029.[5] Furthermore, because of the nature of Federal Trust Funds, HI and OASDI Trust Fund balances do not provide meaningful information about program sustainability—that is, the government's fiscal capacity to pay benefits when the program's cash income falls below benefit expenses. From this perspective, the net cash impact of the trust funds on the government as a whole—not trust fund solvency—is the important measure. Under the trustees' intermediate assumptions, the OASDI Trust Funds are projected to have a cash deficit beginning in 2016 and the HI Trust Fund a deficit also beginning in 2016. (See fig. 4.) At that point, the programs become net claimants on the Treasury. In addition, as we have noted in other testimony,[6] a focus on HI solvency presents an incomplete picture of the Medicare program's expected future fiscal claims. The Supplementary Medical Insurance (SMI) portion of Medicare, which is not reflected in the HI solvency measure, is projected to grow even faster than HI in the near future. According to the best estimates of the Medicare trustees, Medicare HI and SMI together will double as a share of GDP between 2000 and 2030 (from 2.2 percent to 4.5 percent) and reach 8.5 percent of GDP in 2075. Under the trustees' best estimates, Social Security spending will grow as a share of GDP from 4.2 to 6.5 percent between 2000 and 2030, reaching 6.7 percent in 2075.

[5] In the Fiscal Year 2000 *Financial Report of the United States Government*, issued in March 2001, the net present value of the estimated expenditures in excess of income as of January 1, 2000, was $3.8 trillion for Social Security and $2.7 trillion for Medicare Part A. The 2001 figures will be available at the end of next month.

[6] *Medicare: New Spending Estimates Underscore Need for Reform* (GAO–01–1O1OT, July 25, 2001).

Figure 4: Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits as Baby Boomers Retire



Note: Projections based on intermediate assumptions of the 2001 OASDI and HI reports.

Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration and the Office of the Actuary, Health Care Financing Administration.

Note: Projections based on intermediate assumptions of the 2001 OASDI and HI reports.

Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration and the Office of the Actuary, Health Care Financing Administration.

To finance these cash deficits, Social Security and the Hospital Insurance portion of Medicare will need to draw on their special issue Treasury securities acquired during the years when these programs generated cash surpluses. This negative cash flow will placed increased pressure on the Federal budget to raise the resources necessary to meet the program's ongoing costs. In essence, for OASDI or HI to "redeem" their securities, the government will need to obtain cash through increased taxes, and/or spending cuts, and/or increased borrowing from the public (or correspondingly less debt reduction than would have been the case had cash flow remained positive).

Our long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the government will be called upon to address. As we have stated elsewhere,[7] early action to change these programs would yield the highest fiscal dividends for the Federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to build economic resources and reform future claims entails risks. First, we lose an important window where today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. We lose the opportunity to reduce the burden of interest in the Federal budget, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift. Unfortunately, the long-range challenge has become more difficult, and the window of opportunity to address the entitlement challenge is narrowing. It remains more important than ever to return to these issues over the next several years. Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the promised benefits now and in the future and at what cost to other claims on scarce resources.

The Need To Reexamine Government Activities and Programs

One of the reasons to address these longer-term pressures is their potential to crowd out the capacity to support other important priorities throughout the rest of the budget. The tragedy of September 11 made us all realize the benefits fiscal flexibility provides to our Nation's capacity to respond to urgent and newly emergent needs. Obviously we will allocate whatever resources are necessary to protect the Nation. However, these new commitments will compete with and increase the pressure on other priorities within the budget. Financing these compelling new claims within an overall fiscal framework that eventually returns the budget to surplus is a tall order indeed.

The budget process is the one place where we as a Nation can conduct a healthy debate about competing claims and new priorities. However, such a debate will be needlessly constrained if only new proposals and activities are on the table. A fundamental review of existing programs and operations can create much-needed fiscal flexibility to address emerging needs by weeding out programs that have proven to be outdated, poorly targeted, or inefficient in their design and management. It is always easier to subject proposals for new activities or programs to greater scrutiny than that given to existing ones. It is easy to treat existing activities as "given" and force new proposals to compete only with each other. Such an approach would move us further, rather than nearer, to budgetary surpluses.

Moreover, it is healthy for the Nation periodically to review and update its programs, activities and priorities. As we have discussed previously,[8] many programs were designed years ago to respond to earlier challenges. In the early years of a new century, we have been reminded how much things have changed. For perspective, students who started college this past fall were 9 years old when the Soviet Union broke apart and have no memory of the Cold War; their lifetimes have always known microcomputers and AIDS. In previous testimony,[9] both before this Com-

[7] *Major Management Challenges and Program Risks: A Governmentwide Perspective* (GAO–01–241, January 2001), p. 45.

[8] *Budget Issues: Effective Oversight and Budget Discipline are Essential—Even in a Time of Surplus* (GAO/TAIMD–00–73, Feb. 1, 2000).

[9] *Homeland Security: Challenges and Strategies in Addressing Short- and Long-Term National Needs* (GAO–02-160T, Nov. 7,2001) and *Budget Issues: Effective Oversight and Budget Discipline are Essential—Even in a Time of Surplus* (GAO/T–AIMD–00–73, Feb. 1, 2000).

mittee and elsewhere, I noted that it should be the norm to reconsider the relevance or "fit" of any Federal program or activity in today's world and for the future. Such a review might weed out programs that have proven to be outdated or persistently ineffective, or alternatively could prompt us to update and modernize activities through such actions as improving program targeting and efficiency, consolidation, or reengineering of processes and operations. Ultimately, we should strive to hand to the next generations the legacy of a government that is effective and relevant to a changing society—a government that is as free as possible of outmoded commitments and operations that can inappropriately encumber the future. We need to think about what government should do in the 21st century and how it should do business.

The events of last fall have provided an impetus for some agencies to rethink approaches to long-standing problems and concerns. In particular, agencies will need to reassess their strategic goals and priorities to enable them to better target available resources to address urgent national preparedness needs. For instance, the threat to air travel has already prompted attention to chronic problems with airport security that we and others have been pointing to for years. Moreover, the crisis might prompt a healthy reassessment of the broader transportation policy framework with an eye to improving the integration of air, rail, and highway systems to better move people and goods.

Other long-standing problems also take on increased relevance in today's world. Take, for example, food safety. Problems such as overlapping and duplicative inspections across many Federal agencies, poor coordination, and inefficient allocations of resources are not new and have hampered productivity and safety for years. However, they take on new meaning and urgency given the potential threat from bioterrorism. We have argued for a consolidated food safety initiative merging the separate programs of the multiple Federal agencies involved. Such a consolidated approach can facilitate a concerted and effective response to the new threats.

The Federal role in law enforcement is another area that is ripe for reexamination following the events of September 11. In the past 20 years, the Federal Government has taken on a larger role in financing criminal justice activities that have traditionally been viewed as the province of the State and local sector. This is reflected in the growth of the Federal share of financing—from 12 percent in 1982 to nearly 20 percent in 1999.

Given the new daunting new law enforcement responsibilities in the wake of September 11 and limited budgetary resources at all levels, the question is whether these additional responsibilities should prompt us to rethink the priorities and roles of Federal, State, and local levels of government in the criminal justice area and ultimately whether some activities are affordable in this new setting. The Federal Bureau of Investigation has already begun thinking about reprioritization and how its investigative resources will shift, given the new challenges posed by the terrorism threat.

With the Coast Guard's focus on homeland security, it has de-emphasized some of its other critical missions in the short term, most notably fisheries enforcement and drug and migrant interdiction. The Coast Guard is currently developing a longer-term mission strategy, although it has no plans at present to revise the schedule or asset mix for its Deepwater Project (which will be awarded mid–2002).

In rethinking Federal missions and strategies, it is important to examine not only spending programs but the wide range of other more indirect tools of governance the Federal Government uses to address national objectives. These tools include loans and loan guarantees, tax expenditures, and regulations. For instance, in fiscal year 2000, the Federal health care and Medicare budget functions include $37 billion in discretionary budget authority, $319 billion in entitlement outlays, $5 million in loan guarantees, and $91 billion in tax expenditures.

The outcomes achieved by these various tools are in a very real sense highly interdependent and are predicated on the response by a wide range of third parties, such as States and localities and private employers, whose involvement has become more critical to the implementation of these Federal initiatives. The choice and design of these tools is critical in determining whether and how Federal objectives will be addressed by these third parties. Any review of the base of existing policy should address this broader picture of Federal involvement.

GAO has also identified a number of areas warranting reconsideration based on program performance, targeting, and costs. Every year, we issue a report identifying specific options, many scored by CBO, for congressional consideration stemming from our audit and evaluation work.[10] This report provides opportunities for (1) re-assessing objectives of specific Federal programs, (2) improved targeting of benefits, and (3) improving the efficiency and management of Federal initiatives.

Just as long-standing areas of Federal involvement need re-examination, so proposed new initiatives designed to address the new terrorism threat need appropriate review. With the focus on counter-terrorism, you will undoubtedly face many proposals redefined as counter-terrorism activities. The Congress will need to watch for the redefinition of many claims into counter-terrorism activities. It will be especially important to seek to distinguish among these claims.

In sorting through these proposals, we might apply investment criteria in making choices. Well-chosen enhancements to the Nation's infrastructure are an important part of our national preparedness strategy. Investments in human capital for certain areas such as public health or airport security will also be necessary as well to foster and maintain the skill sets needed to respond to the threats facing us. A variety of governmental tools will be proposed to address these challenges—grants, loans, tax expenditures, and/or direct Federal administration. The involvement of a wide range of third parties State and local governments, nonprofits, private corporations, and even other Nations—will be a vital part of the national response as well.

In the short term, we will do whatever is necessary to get this Nation back on its feet and compassionately deal with the human tragedies left in its wake. However, as we think about our longer-term preparedness and develop a comprehensive homeland security strategy, we can and should select those programs and tools that promise to provide the most cost-effective approaches to achieve our goals.

Budget Process Should Facilitate Discipline and Awareness of Long-term Implications of Decisions

Today the Congress faces the challenge of sorting out these many claims on the Federal budget without the fiscal benchmarks and rules that served as guides through the years of deficit reduction. Going forward, new rules and goals will be important both to ensure fiscal discipline as we sort through these new and compelling claims and to prompt policymakers to focus on the longer-term implications of current policies and programs. For more than a decade, budget process adaptations have been designed to reach a zero deficit. With the advent of surpluses, a new framework was needed—one that would permit accommodating pent-up demands but not eliminate all controls. A broad consensus seemed to develop to use saving the Social Security surplus or maintaining on-budget balance as a kind of benchmark. However, the combination of the economic slowdown and the need to respond to the events of September 11 has overtaken that measure.

Once again, Congress faces the challenge of designing a budget control mechanism. Last October, Mr. Chairman, you and your colleague Senator Domenici and your House counterparts called for a return to budget surplus as a fiscal goal. This remains an important fiscal goal, but achieving it will not be easy. In the near term, limits on discretionary spending may be necessary to prompt the kind of re-examination of the base I discussed above. There are no easy choices. There will be disagreements about the merits of a given activity—reasonable people can disagree about Federal priorities. There may also be disagreements about the appropriate response to program failure: Should the program be modified or terminated? Would the program work better with more money or should funding be cut? Spending limits can be used to force choices; they are more likely to do so, however, if they are set at levels viewed as reasonable by those who must comply with them.

Spending limits alone cannot force a re-examination of existing programs and activities. However, the recognition that for most agencies the new responsibilities acquired since September 11 cannot merely be added to existing duties requires that decisions be made about priorities. In the last decade Congress and the Administration put in place a set of laws designed to improve information about cost and performance. This information can help inform the debate about what the Federal Government should do. In addition, the budget debate can benefit from the kind of framework I discussed above. In previous testimony before this committee, I suggested that Congress might equip itself to engage in this debate by developing a congressional performance resolution to target its oversight on certain government-wide performance issues cutting across agencies and programs.[11] Along with caps,

[10] *Supporting Congressional Oversight. Framework for Considering Budgetary Implications of Selected GAO Work* (GAO–0l–447, March 9, 2001).

[11] *Budget Issues: Effective Oversight and Budget Discipline Are Essential Even in a Time of Surplus* (GAO/TAIMD–00–73, Feb. 1, 2000).

this and other measures might help ensure that Congress becomes part of the debate over reprioritization and government performance.

The dramatic shift in budget projections since last year has prompted discussion of shortening the budget window. This may well be a sensible approach to reducing uncertainty. However, such a change should be coupled with steps to provide a broader and longer-term fiscal horizon: goals and metrics to address the longer-term implications of today's choices. This does not mean that we should budget for a 20- or 30-year period. It does mean considering establishing indicators and targets that bring a long-term perspective to budget deliberations and a process that prompts attention to the long-term implications of today's decisions. Periodic simulations along the lines we and CBO have developed can and should become a regular feature of budget debate. We would be the first to say that the simulations are not predictions of the future or point estimates, rather they serve as indicators—or warning lights—about the magnitude and direction of different policy profiles. These scenarios are particularly helpful in comparing long-term consequences of different fiscal paths or major reforms of entitlements using the same assumptions. As I said earlier, the demographic tidal wave that drives the long-term budget challenge is a known element with predictable consequences.

Some kind of fiscal targets may be helpful. As a way to frame the debate, targets can remind us that today's decisions are not only about current needs but also about how fiscal policy affects the choices over the longer term. Other Nations have found it useful to embrace broader targets such as debt-to-GDP ratios, or surpluses equal to a percent of GDP over the business cycle. To work over time targets should not be rigid—it is in the nature of things that they will sometimes be missed. It should be possible to make some sort of compelling argument for the target—and it should be relatively simple to explain. Reaching a target is not a straight line but an iterative process. The other Nations we have studied have found that targets prompted them to take advantage of windows of opportunity to save for the future and that decisionmakers must have flexibility each year to weigh pressing short-term needs and adjust the fiscal path without abandoning the longer-term framework.

In re-examining what I have called the "drivers" of the long-term budget, we need to think about new metrics. We have been locked into the artifacts of the trust funds, which do not serve as appropriate signals for timely action to address the growth in these programs. As I mentioned earlier, trust fund solvency does not answer the question of whether a program is sustainable.

Although aggregate simulations are driven by these programs, the need for a longer-term focus is about more than Social Security and Medicare. In recent years there has been an increased recognition of the long-term costs of Social Security and Medicare. While these are the largest and most important long-term commitments—and the ones that drive the long-term outlook—they are not the only ones in the budget that affect future fiscal flexibility. For Congress, the President, and the public to make informed decisions about these other programs, it is important to understand their long-term cost implications. A longer time horizon is useful not only at the macro level but also at the micro-policy level. I am not suggesting that detailed budget estimates could be made for all programs with long-term cost implications. However, better information on the long-term costs of commitments like employee pension and health benefits and environmental cleanup could be made available. Here again, new concepts and metrics may be useful. We have been developing the concept of "fiscal exposures" to represent a range of Federal commitments—from explicit liabilities to implicit commitments. Exactly how such information would be incorporated into the budget debate would need to be worked out—but it is worth serious examination.

Conclusion

In one sense much has changed in the budget world since last February. There are even more compelling needs and demands on the Federal budget than a year ago—and policymakers must deal with them absent the surpluses that were projected then. However, the demographic trends that drive the long-term outlook have not changed. The baby boom generation is still getting older and closer to retirement. Because of the coming demographic shift, the message from our simulations remains the same as last year, indeed as since we first published results from our long-term model in 1992: Absent changes in Social Security and health programs, in the long term, persistent deficits and escalating debt driven by entitlement spending will overwhelm the budget.

The events of September 11 highlighted the benefits of fiscal flexibility. Addressing the long-term drivers in the budget is essential to preserving any flexibility in the long term. In the nearer term a fundamental review of existing programs and operations can create much-needed fiscal flexibility to address emerging needs by weeding out programs that have proven to be outdated, poorly targeted, or inefficient in their design and management.

Congress and the President stand at a point where current needs and wants must be balanced against known long-term pressures. And you face the challenge of sorting out these many claims on the Federal budget without the fiscal benchmarks and rules that guided us through the years of deficit reduction into surplus. Going forward, new rules and goals will be important both to ensure fiscal discipline and to prompt a focus on the longer-term implications of decisions. It is still the case that the Federal Government needs a decision-making framework that permits it to evaluate choices against both today's needs and the longer-term fiscal future that will be handed to future generations. As stewards of our Nation's future, we must begin to prepare for tomorrow. In this regard, we must determine how best to address these structural challenges in a reasonably timely manner in order to identify specific actions that need to be taken.

None of this is easy. We at GAO stand ready to assist you.

Chairman CONRAD. I thank you very much for that testimony.

Let me just say that the importance of this hearing today to me is to share with our colleagues how really big the problem is that we have. And you are quite right to indicate this is a problem that has gotten worse in the last year, but it was very big before then. It is why last year I advocated a budget that saved all the Social Security and Medicare Trust Fund surpluses for the purposes intended. It also set aside $900 billion of general fund money to prepay liability. That is what other countries are doing that face this same kind of demographic wave—at least some of them. And I also believe that that would foster economic growth because you would pay down debt with that money, and that would mean theoretically lower interest rates, more money in national savings, more money available for investment, which should lead to greater economic growth.

That course was not chosen, and I don't ask you to pass judgment on that. You are in a position of not recommending policy. Your job is to tell us where we are headed and how serious and how deep the hole is. And you have done that, and you have done it in a clear way.

Let me ask you this: Is it your judgment that we ought to attempt to restore surpluses and build surpluses as the economy recovers? I take it from your testimony that that is part of your advice to us.

Mr. WALKER. That is consistent with what we have said in prior years. And in my testimony I said that—and I think it is also consistent with what the Congress has stated that it wants to do, that it wants to be able to return to surplus. What I am telling you is that it has become more difficult, and it is going to be progressively more difficult because of the factors that I have articulated before.

Chairman CONRAD. How important a role, in your judgment, does increasing the rate of national savings play in our ability to cope with these future challenges?

Mr. WALKER. National saving is critically important. As you noted before, national saving will fuel investment. Investment help to fuel productivity increases. Productivity increases help to increase our economy, and they also help to improve the standard of living for all Americans.

You were right before that most of the increase in net national saving over the past decade have been a result of the Congress' effort to create surpluses. That is true. Individual saving, personal saving, as currently measured, continues to be abysmally low, and it is something that we are going to have to figure out how best to address, but we have not been successful to date.

Chairman CONRAD. Would somebody listening to you be incorrect to conclude, from what you have said here today, that we have got to restrain both our appetite for spending and our appetite for additional tax cuts? Would that be an appropriate conclusion?

Mr. WALKER. We need to do two things, without getting that specific, Mr. Chairman. We need to, I believe, consider the fiscal risk associated with a range of policy choices.

Last year, I would commend to you and other members of the Committee, one of the things that I presented in my testimony was a chart that talked about different types of actions that the Congress could take and the different degrees of fiscal risk that each of those actions would represent. I suggested that the Congress might want to look at what it is doing in the budget area, and otherwise, as part of portfolio management, which I know, Senator Corzine, you are very familiar with. As part of portfolio management, to consider not only the short-term flexibility, but the long-term implications as policy relates to its overall impact on future fiscal risk for the country.

I noted in there that, obviously, to the extent that you end up taking certain types of actions, whether it be on the spending side or the tax side, they represent higher risk. I noted, also, that I felt that the highest risk was permanent increases in entitlement spending, where we already have trillions of unfunded obligations associated with those programs.

Chairman CONRAD. Let us talk a little bit about those unfunded obligations. Chairman Greenspan, in a meeting with me before he testified here, told me one of his concerns as we go forward are the so-called contingent liabilities of the Federal Government, contingent liabilities of major entitlement programs, Social Security and Medicare, that are not carried on the books of the Federal Government on the theory that Congress could end those programs on short notice. Therefore, they were considered contingent liabilities.

He said to me he views the vast majority of those commitments as not contingent at all. Would you agree with his assessment?

Mr. WALKER. Well, let me tell you, first, what the current treatment is, and then I will address that.

One of the first things that I did when I came to GAO, given my background and concerns about some of these issues, was to work with the Financial Accounting Standards Advisory Board, which is the body that promulgates general accepted accounting principles for the Federal Government, to increase the transparency and to enhance the visibility of our long-range, unfunded commitments associated with Social Security and Medicare.

Now, today, we have separate statements in the consolidated financial statements of the United States Government dedicated to these programs and, for the first time, we not only demonstrate information that is in the trustees' reports that come out every year, but we show the discounted present value of the unfunded promises associated with these programs, where there has been a——

Chairman CONRAD. How big are those unfunded liabilities? This is my last question, and then we will go to Senator Snowe.

Mr. WALKER. Those numbers are noted in a footnote in my statement. This is based on last year's report. In the fiscal 2000 financial report of the United States Government, on Page 7, footnote 5, $3.8 trillion, in current dollars, for Social Security; $2.7 trillion for Part A alone. The problem with Medicare is much greater than Social Security. And Medicare, while that by itself is much greater than Social Security, that does not count Medicaid. So, in reality, our problem in health care is multiple times our problem in Social Security.

Chairman CONRAD. Could you just repeat that. How much of the $3.8 trillion is attributable—this is unfunded liability—how much of it is attributable to Social Security and how much to Medicare?

Mr. WALKER. Well, right now, $3.8 trillion, discounted present value, the difference between projected revenues, projected costs, $3.8 trillion, as of last year for OASDI, which is the Old Age Survivors and Disability Insurance. So it is both the retirement income and the disability program.

For Part A, which is hospital insurance, HI, which, as you know, is funded by a payroll tax similar to Social Security, it is $2.7 trillion. But that does not count Part B, which is supplemental medical insurance which is, as you know, funded primarily by general revenues, and it does not count Medicaid. And so, when you look at it as a percentage of the economy, as a percentage of the budget, which I also provide in my statement, the health care problem is much greater than the Social Security problem.

Chairman CONRAD. I think that is too little understood. You have presented that before to this Committee. I wish the word would go out that these are the realities of what we confront as a Nation. There is a train wreck coming, folks. There is a train wreck coming, and it is of enormous proportion, and we better wake up before it is too late.

I have attributed or likened this to Enron in the sense that Enron got in trouble, I believe, because they were hiding debt. They were running all of these off-balance sheet operations, and fundamentally hiding debt from the investment community, hiding it from their creditors, perhaps even hiding it from themselves.

I worry very much that that is going on in this Government, that we are not facing up to the true debt that the country faces. We keep talking about surpluses. In my judgment, there are no surpluses. The surpluses are all gone. This money that is called surplus is committed. It is overcommitted, and yet we use the word "surplus." It misleads people.

People conclude from that we have got extra money here, so we can spend more, we can have more tax cuts, and I think the reality of what you are telling us here today is the numbers do not add up. I use your words. The numbers do not add up, and we have got to face up to this as a country, as a Congress, and as a Budget Committee. We have got an obligation, an affirmative obligation, to tell our colleagues where this is all headed. Because I can tell you the appetite for more spending, for more tax cuts is totally out of the box. The gate is wide open.

I will tell you I have a parade of people coming to me, and they want more tax cuts, more spending, and the whole thing does not add up now.

Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman.

Mr. Walker, continuing on the Medicare issue for a moment, how much worse is the Medicare program with respect to so-called surpluses? The fact is, as you know, a few years ago we shifted home health care services from Part A to Part B, so I think it camouflages, essentially, the real condition of the Medicare program with respect to the Part A fund.

Mr. WALKER. Senator, your point is outstanding. I mean, the fact of the matter is it reinforces the fact that we cannot focus solely on the trust fund issue, and we cannot focus just on Part A versus Part B. We need to look at Medicare on a consolidated basis. We need to look at it as a percentage of the budget. We need to look at it as a percentage of the economy.

These are metrics that are more meaningful than the trust fund. The trust fund just deals with solvency. It does not deal at all with sustainability or, stated differently, affordability.

Senator SNOWE. What would be the timeframe necessary to affect the position of both Social Security and Medicare in the years when it begins to have a negative revenue effect, in the year 2016, as you mentioned? So how many years in advance would we have to effect that date, in terms of a change of policy, that would begin to have a more positive outflow?

Mr. WALKER. Obviously, it is the old story; the sooner the better. As you know, Senator, is it is difficult to make changes to these programs. Historically, what has happened is there has had to be some type of a compelling event or condition that existed where Congress was forced to act. That is what happened in 1983 with the Greenspan commission. The checks were not going to go out. Well, needless to say, that is not an acceptable outcome for a variety of reasons, and so therefore that commission was formed to try to deal with an impending solvency problem. The checks were not going to go out.

We face a different problem today, and that is we do not have an immediate problem, but we have a major long-range problem, and we are much better off to try to start dealing with it earlier.

My personal view is, Senator, having been a trustee of Social Security and Medicare, having been involved in this for years, we can actually exceed the expectation of all generations of Americans for Social Security. The way you can do that is because, for current retirees and near-term retirees, if the Congress decided you were going to give them everything they have been promised, because, that is arguably the right thing to do since they do not have time to make adjustments, and from a practical standpoint, politically, it would probably be difficult to do anything else, and if you decided to restructure the Social Security program progressively, more changes for baby boomers, more changes for Generation Xers, then you will be able to exceed the expectations of all generations of Americans because baby boomers and Generation Xers are discounting what they think they are going to get under this program.

Now, in many cases, they are discounting it more than they should be discounting it. So there is a window of opportunity to restructure that program to make it not only solvent, but sustainable, and affordable, and exceed the expectations of all generations of Americans. We just have to get on with doing it.

On health care, that scenario does not exist. The gap between promises, and affordability and the expectation gaps, unfortunately, go in the other direction.

Senator SNOWE. On the issue of economic growth because, obviously, that had a significant effect on projected surpluses over the next 10 years, and, frankly, I think it was rather startling what we saw. I mean, with the reduction of economic growth in years 2002 and 2003, that led to a reduction in surpluses of $1.6 trillion over the next 10 years. So, even a minuscule adjustment in economic growth could work for us or against us.

I guess, what are your projections for economic growth over the next 10 years in the long run?

Mr. WALKER. We use CBO's.

Senator SNOWE. You use CBO's.

Mr. WALKER. We do not compete with CBO. They are the agency that Congress has chosen to make those types of assumptions, and we basically build upon what they do.

Senator SNOWE. Well, I think that in looking at this entire issue, and I do not know how we can do it differently, but I think it really does magnify the problems that we face with the tenuous nature of these projections in predicating, you know, a number of programs and expenditures on illusory projections because these revenues have not materialized. Just the spending that we have agreed to over the last few years has had an impact of more than $1.2 trillion in surpluses over the next 10 years.

So it may be that we do this, but having some sort of impact on the surplus on some of these programs that we pass, so that we have a clear idea of what we are doing each and every time in reducing the surpluses. The aggregate impact, I mean, was astonishing for the spending that we agreed to over the last few years.

Mr. WALKER. Senator, we need some new metrics because the current ones are expiring this year, and we in GAO have done work, to look at what other countries have done, and we have made it available to Congress, and I am happy to make it available again as to how to do that.

Let me give you an analogy that I talked to Senator Corzine about just a few minutes before the hearing started, and that is our budget situation is very similar to what Christopher Columbus faced in his day. That was there was great debate about whether the Earth was flat or whether the Earth was round. Christopher Columbus thought it was round. Many others bet that it was flat, and he was going to go off the end of the Earth.

We have to recognize that, while there is inherent difficulties in even projecting 10 years, clearly, that is difficult enough, and while there is even greater uncertainty when you go further out, the fact of the matter is the Earth is round, and there is a tidal wave beyond the 10-year horizon. That tidal wave is called the baby boom generation, and that is not going away, and we have got to start dealing with it.

Senator SNOWE. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Stabenow.

Senator STABENOW. Well, thank you, Mr. Chairman, as usual, for holding these hearings and giving us an opportunity to hear what is facing us. I appreciate, Mr. Walker, your public service and willingness to come forward and talk exactly about the facts of the situation.

Senator Snowe was talking about spending and how we have projected spending increases and impacts on the budget from decisions that have been made. I was sitting here doing some numbers, and when we look at the impact of the tax cut that was passed last year, and we look at what you are projecting in terms of unfunded liability, I find it interesting, at this point, we not only have choices about spending, we have choices about tax policy.

In the next 10 years—or between now and the end of this decade—we are looking at $1.7 trillion coming out of the Federal budget as a result of the tax cut, and in the next 10 years, $4 trillion. You indicated to us there is a $3.8-trillion unfunded liability; is that what I understand?

Mr. WALKER. As of today. That is just for Social Security.

Senator STABENOW. So we are looking at $3.8-, in terms of Social Security unfunded liability, $4 trillion on the other side. I do not see how we can escape having a discussion about all of the decisions that have been made, not just part of the decisions that have been made, and the impact of that when we look at the fact that you were projecting a $2-trillion gap out into the future, and when you look at $4 trillion in lost revenue in the second 10 years of the tax cut. That is part of our challenge.

I know, Mr. Chairman, that you know that and have spoken eloquently, on many occasions, but there is a direct impact between what was done last year, not only spending, but I would argue even more so on the tax policy side and what you are talking about.

Given that, you have mentioned in your testimony that fiscal targets may be helpful as a new kind of budget mechanism, and I am wondering what you hand in mind. I am surprised that Senator Snowe did not mention what we usually talk about here, in terms of our working together on some kind of a budget trigger mechanism. But I am wondering, when you mention in your written testimony about fiscal targets, what you had in mind and if you feel there is a way to craft some kind of mechanism that would slow down the phase-in on either spending or tax cuts if we do not generate growth in the economy to be able to pay for that without going into debt.

Mr. WALKER. Thank you, Senator. Two things. On your first point, we advocated last year, and continue to advocate, the total portfolio management approach. You need to look at the tax side, the spending side, you need to look at it all and consider the fiscal risk.

Second, in my statement and also some other reports we do talk about some possible metrics or measures that the Congress could consider once the current ones expire; certain things as, for example, the percentage of debt to GDP. I know, Mr. Chairman, you expressed concerns about where they are going if we do not do something. So there are several ones that we have specifically laid out.

There are other ones that we would be happy to talk with you and the Committee about.

I think it is important that we have something. I think the other thing that is important is also to make sure that we do not just use those measures with regard to where we stand today.

We need to consider what are the longer term implications of current policy choices; in other words, not just where you stand on these metrics today, but if these were to become law, where is that going to take us in trying to deal with our longer range challenges because that is really the problem. There are a lot of things we can afford to do today, but in all likelihood we are not going to be able to sustain and afford them tomorrow.

Senator SNOWE. Thank you. I would just comment, in conclusion, for the record, because I always feel compelled, when we are talking about the tax cuts, to reiterate the fact that I support tax cuts. I think we all support tax cuts. The question is to whom and what impact they have on the economy, how they fit in the overall discussion on priorities.

My biggest concern right now, as it relates to what is unfolding with the tax cut, is that too many people, too many of my constituents, in fact, members of my own family now that are doing their taxes are finding out that the $300 they were given in the tax cut last spring or summer were actually advances on their tax liability. They are not very happy about that. And then when I explain to them that most of the rest of the tax cut, they will not be receiving, they are not very happy about that either.

When we put that in context, when we look at who is going to receive those tax cuts versus who benefits by Social Security, and Medicare, and the other funds that are going to be paying for that tax cut, I think it is very disturbing. I know you cannot comment on that, but I would just indicate that I think we have some very important choices to debate.

Mr. WALKER. Thank you, Senator.

Chairman CONRAD. Senator Corzine?

Senator CORZINE. Thank you, Mr. Chairman.

Mr. Walker, I am going to just take a step along the line that Senator Stabenow was talking about. She talked about in the next 20 years the 1.7 in the first 10 years and 4 trillion in the next 10 years, of the cost of the tax cut. If our people are doing this right, and actually I would love to have GAO do one of those lines breaking out discretionary spending and tax cut issues on that chart that you talked about, if you had it, if you did not have it, because I think those actually would give us some of the tradeoff judgments that we have to make, not a perfect tradeoff, but it allows us to see the policy implications of the tax cuts' costs to revenues and the discretionary spending's cost to revenues and implications for the economy.

But if we are doing it right, over the next 75 years, the timeframe that this footnote is addressing with regard to Social Security and Medicare, the tax cut is going to cost $7.7 trillion, and the addition here of the two pieces that you talked about on Social Security and Medicare are 6.5 trillion. I know that does not allow for Medicare, Medicaid and Part B, but we did make a choice that we have pulled away revenues. We made choices when we spend money too, I understand, but we ought to understand what the implications of what that foundation is. It is very clear if we had not made that choice, we had the ability at least to cover the discounted values of the obligations that we had coming forward. And it is a matter of policy choice. Could have done that with spending as well, but——

Chairman CONRAD. Although, of course, as you know, Senator Corzine, those would not have been dedicated revenues to Social Security and Medicare, and so whether or not the Congress would have spent that money for those programs is——

Senator CORZINE. There is no question of that, but we did have the resources to meet these unfunded liabilities at our discretion, subject to self help, if we looked at those obligations and said that we wanted to at least dedicate those. And I think that is what the debate about the Social Security Trust Fund is about, is that there are those, as the Chairman has repeatedly stressed, that setting that aside leads to the kinds of implications that we might potentially have had the ability to meet those unfunded liabilities over a period of time. We clearly do not have that ability with the $7.7 trillion cut in taxes.

We have got, as you suggest, a portfolio of choices that we have to deal with here. One of the things I would love to see in that portfolio of choices is that same chart that you had, the very first one. You talked about both discretionary spending, how that chart would look if that was held the same, and then without those tax cuts, I think you would see a substantially—you would see a clear breakout of the choices.

Let me talk about something that is less controversial, about the value of tax cuts or not. Do we, anywhere in Government actually provide the transparency of what we are paying or what we are charging ourselves with regard to tax expenditures as opposed to cash expenditures? It seems to me that as we sit and debate policy choices in the Congress, it is very easy to identify what our expenditures are on programmatic issues where dollars go out the door. But when it comes to tax expenditures, whether it is for an individual tax break for a company or whether it is for 401(k) programs and pension retirements, it is very difficult to understand the discretionary choices we have made because those things are enacted into a tax code.

Is there a place where we could get a perspective on what we are actually doing with regard to tax expenditures, so that we could make the choice of whether tax expenditures were sensible relative to cash expenditures, which we are making on spending?

Mr. WALKER. Senator, that is an excellent question. My understanding is the Joint Committee on Taxation does periodically come up with the estimates of the amounts associated with current tax preferences. They call them expenditures. I would argue in certain circumstances that might be a fair term; in other circumstances it would not be.

For example, some of those tax preferences are timing differences, as you know. The tax preferences that are provided to pension plans represent a timing difference. The employer gets the deduction today. The trust gets income exclusion—pardon me—

does not pay taxes. But ultimately taxes are paid by the individuals when the benefits are paid out. Health care is very different.

Senator CORZINE. The value of money is real.

Mr. WALKER. Correct, absolutely.

Senator CORZINE. And not a—I mean we have been talking about discounted values here.

Mr. WALKER. Absolutely. But I think the important point that you touch on is when you look at portfolio management. I would argue another thing that we need to be looking at that we have not been looking at adequately is all the tools of Government. The Government has many tools available to it to achieve policy outcomes that only elected officials can decide what those desired outcomes are. It has spending. It has guarantees. It has regulatory policy, and it has tax policy among other things.

And I think one of the things that we do not have adequate transparency enough on are the tax aspect. And in addition, one of the things that we have not done as good a job on, which we believe there is a need to do it, is take an area and look at the totality of support. Take, for example, health care. Do not just look at Medicare, Medicaid, spending on Federal health care, et cetera for Federal employees, also look at tax preferences accorded to health care. What about the regulatory policies in the area? When you look at it that way, you get a very different perspective and the numbers are even larger by order of magnitude.

So I think we need to figure out a way that we can look at all the tools of Government and analyze the impact of all the tools of Government in an area. Are they achieving the intended purpose? What is the cost versus the benefit, if you will, of these different options?

Senator CORZINE. Mr. Chairman, one of the hopes that I would have is that we would do as much scrubbing of tax preferences and tax incentives, which are expenditures or a like judgment on public policy as we do with regard to discretionary spending issues. And it never was more clearly illustrated, at least in my view, than in the tax cut that we have when you put the $7.7 trillion against the 6.5 that is itemized here. But that permeates a whole series of judgments that we make on health care as the Comptroller General said. I thank you very much.

Mr. WALKER. Senator, let me add one thing. It was just brought it to my attention. On page 11 we have one example, and I will just read it for the record. "For instance, in fiscal 2000 Federal health care and Medicare budget functions include $37 billion in discretionary budget authority, $319 billion in entitlement outlays, $5 million in loan guarantees, and $91 billion in tax expenditure."

So that is part of total portfolio management.

Senator CORZINE. Thank you.

Chairman CONRAD. Thanks, Senator Corzine.

Let me if I could, ask you, Director Walker. If we were to—you had in one of your charts if the tax cuts do not sunset.

Mr. WALKER. Right.

Chairman CONRAD. Do you know what the cost is in the second 10 years if the tax cuts are made permanent? I think the cost in this 10-year period if 400 billion. Do you now what it is in the second 10 years?

Mr. WALKER. I do not, but I can provide it for the record, Mr. Chairman.

Chairman CONRAD. Would it surprise you if Joint Tax is telling us it would be $4 trillion?

Mr. WALKER. We have not had a chance to review it. We have heard that assertion, but we have not had a chance to review it.

Chairman CONRAD. That is what they are telling us, $4 trillion. You have indicated that one of the great challenges we face is the entitlement programs. I agree with you. It is very clear, just as clear as it can be from the analysis that you have provided. Unfunded liability and Social Security $3.8 trillion, unfunded liability in just Medicare Part A, $2.7 trillion. So that is $6.5 trillion of unfunded liability. You know, I think these numbers are so big that it does not sink in to people what it means. What it means is that a future Congress and future President are going to be faced with the most agonizing of decisions. They are going to be faced with either deep benefit cuts and/or massive tax increases, and tremendous increases in indebtedness. Is that not so?

Mr. WALKER. Unless we do something different. I think part of the problem, Mr. Chairman, is how can we go about trying to address this sooner rather than later. And what I found over the years is that when you have a big problem like this, where the tendency is more to focus on the here and now for a variety of reasons, you need to be able to put a face on it in order to help people. And I think the faces are there. They are our children and our grandchildren. Those are the faces we need to put on it.

Chairman CONRAD. No, I am struggling with this——

Mr. WALKER. They are the ones that are going to have the——

Chairman CONRAD. I am struggling with this right now, struggling with how I communicate to my colleagues and how we communicate to a broader audience the message that you have delivered here today. We have got big, big challenges facing this Nation in the future, and they are unlike what we have faced in the past because of the demographic changes. That is a big word, demographic changes. That is just that the retiring generation, the baby-boom generation is much larger in numbers than previous retiring generations, and the ratio between those who are retiring and those who are still working, is shrinking dramatically. Is that not the case?

Mr. WALKER. That is correct. Let me give you a number that I think has helped me over the years. In 1950 there were 16 persons paying into Social Security for every person drawing retirement benefits. Today there are about 3.4 persons paying in for everybody drawing retirement benefits. By the year 2030, and I will verify this for the record, there will be about two persons working for every person drawing retirement benefits. That has dramatic implications in a variety of ways, including fiscal implications.

Chairman CONRAD. And on the Medicare side, obviously, Medicare is begin affected by two significant trends. One is the increase in the number of people who will be eligible for Medicare, just as we seen an increase in the number of people eligible for Social Security. The other major trend is medical inflation being higher than other components in society, the things that we pay for. Is that not the case?

Mr. WALKER. Well, there are several, Mr. Chairman. Those are two. You have the increase in the size population, as you point out. You have the increase in health care inflation above CPI. You have increasing life expectancies. You know, people are going to be eligible for the benefits longer. You have increasing utilization. By that I mean increase in the utilization of different medical procedures that are used, and you have increasing intensity, meaning the sophistication of the type of medical procedures are increasing. Like we did not have MRIs 10 year, and they are fantastic, but they are very expensive. And individuals want to be able to have access to those in some cases where there is a need, in some cases where there is a want. And so there are a variety of factors fueling these costs.

I think one of the biggest problems we have in health care is we have inadequate incentives to control cost and utilization; inadequate transparency to try to provide reasonable assurance that we can do that, and inadequate accountability over these costs. It is not just the design and the regulations associated with these programs; I think it is also arguably the tax policies associated with these programs.

Chairman CONRAD. Say that again. What are you referring to with respect to tax policies?

Mr. WALKER. Well, if you look at the tax side—and again, this is something that Congress would have to consider—unlike pensions where it is a timing difference as to when you are going to pay taxes. Under the current situation, employers get a deduction for the value of health care, which arguably makes good sense because if they are not going to get a deduction for the value of health care, then they will end up paying employees cash and drop their health plan, and that is not obviously in anybody's interest to do that.

Individuals get an exclusion. They do not pay any taxes whatsoever on the value of health insurance no matter how lucrative that health insurance is. And I am not talking about health cost. I am talking about the value of health insurance. So therefore they do not have much association with a direct cost to health care. They do not see it that much when these costs are going up. 85 percent of all health care costs are paid for by a third party. In many cases the individuals who got the services do not even see what the bill is before the amount is paid by the third party, so it is no wonder the costs are up.

Chairman CONRAD. And when they do see the bill, they cannot figure it out.

Mr. WALKER. It is difficult to figure out, but normally it is shocking, no matter—the bottom line, it is normally shocking.

Chairman CONRAD. I have just been through this circumstance with my own wife who had surgery, and we get these bills in the mail, and trying to decipher them is no small matter.

Let us go through these effects, because I think they are very, very important to have on the record. We have medical inflation. That is, inflation for medical services is running above inflation for other goods. The number of people eligible for the program is going to dramatically increase, just as the case with Social Security. That is the baby-boom generation. A third you mentioned, life expectancy. Obviously, people are living longer. That means they are going to be eligible for the benefits of Medicare for a longer period. You made the point of utilization. People are utilizing more health services. You mentioned intensity. How would you describe intensity; how would you define it?

Mr. WALKER. More advanced technologies, I mean, if you will, the nature of the services that they are receiving, not just the number but the nature.

Chairman CONRAD. OK. What have we left out? Any other trends or——

Mr. WALKER. Well, I am sure there are others, but those are the big ones.

Chairman CONRAD. Those are the big five we will call it, medical inflation, number of people eligible, life expectancy, utilization and intensity. Would those be the big five trends?

Mr. WALKER. The big five sounds good to me.

Chairman CONRAD. Well, I want to thank you again for coming before us. This message, I believe, cannot be repeated too often, and I encourage you to take every opportunity to share with our colleagues these long-term trends. I know that you will be appearing before the Finance Committee this afternoon.

Mr. WALKER. Correct.

Chairman CONRAD. I hope that you will be discussing this at some level with them this afternoon. I do not know what——

Mr. WALKER. Maybe somebody will ask me a question. Actually, my testimony this afternoon, Mr. Chairman, deals with pension challenges in light of the recent Enron situation, possible reforms that are needed in our pension system as a result of that.

Chairman CONRAD. So that is obviously an important subject as well. I just hope that members of the Finance Committee—I serve on the Finance Committee as well—are exposed to these long-term trends at some point and that they have a chance to really let this settle in, because there is nothing more difficult than focusing on the future. All of the incentives in the political system are to focus on this year. That is where all of the incentive is, and it is extraordinarily difficult to lift up out of that and look over the horizon and see where we are headed, and understand it does not add up, and that history is going to hold us to account. History is going to look back and say, "What were those people thinking of? Are they just fiddling while Rome burns there? Nobody cared about what they were doing to future generations," as you said, not putting a face on the challenge of the future.

And our kids, I think, are going to look back and really wonder, "What were you thinking of? You were there in a position of responsibility, and you did not alert people as to where we were headed?" I hope that cannot be said of this Committee, and I hope that cannot be said of the Congress.

Right now I would hate to have to pass judgment.

But again, you will be recorded favorably in history because you have repeatedly warned the Congress, warned the Administration, warned the country of where this is all headed. And for that I thank you, and I thank you very much.

Mr. WALKER. Thank you, Mr. Chairman.

[Whereupon, at 11:39 a.m., the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 2003 DEFENSE REQUEST: WINNING THE WAR, TRANSFORMATION, AND REFORM ISSUES

THURSDAY, FEBRUARY 28, 2002

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

The committee met, pursuant to notice, at 10:02 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Kent Conrad (chairman of the committee) presiding.

Present: Senators Conrad, Stabenow, Corzine, and Domenici.

Staff Present: Mary Ann Naylor, staff director and Dakota Rudesill, analyst.

For the minority: G. William Hoagland, staff director and Winslow Wheeler, senior analyst for defense.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I first want to thank our witnesses very much for being here this morning. We appreciate them very much, especially in the case of Dr. O'Hanlon—whose wife is due any day now—for being here. We certainly appreciate that. I appreciate all of the witnesses' being here: Mr. Weston, who is the honorary chairman and former CEO of Automatic Data Processing and vice chairman of the Business Executives for National Security, and co-chairman of the Tail to Tooth Commission, which did really very important work helping us understand the defense needs of the country going forward; Michael O'Hanlon, a senior fellow at Brookings Institution, who is a recognized expert on the resources for defense; and Loren Thompson, the chief operating officer of the Lexington Institute. Welcome. It is good to have all of you here. We certainly appreciate your taking the time, and I can say that we look forward to your testimony.

As we all know, the President indicated in the State of the Union that we will spend what it takes to win the war on terrorism, and let the message go forth from this hearing room that Congress is standing shoulder to shoulder with the President in that regard. No adversary should doubt that we are going to provide the resources necessary to defend this Nation and to win this war on terrorism. No adversary should take any comfort in the debate that we will have about what that level of necessity is. That is the strength of America, to have a debate, to have a discussion, so that we can do the things necessary to make certain that America is strong.

Unfortunately, we do face a budget situation that requires us to examine every part of Federal spending. We can't provide a blank check to any part of the Federal Government because, as the chart shows, we are facing trust fund deficits as far as the eye can see. If we look ahead, we can see red ink for the entire next decade.

Understanding the long-term budget outlook requires focus on each of its major elements, including defense, which represents roughly half of all discretionary spending. For several years, I have been pushing for increases for spending in national defense. In the budget I presented last year, I had a larger increase for defense over 10 years than did the President's initial budget because I could see we needed to put more money into defense over the next decade.

And there is no question that a further defense increase is needed in 2003. However, serious questions deserve to be asked about the President's request, and I will discuss those in detail in the question and answer, but let me first turn to a couple of charts to frame the debate on defense spending.

Defense is clearly a major priority in the President's budget. Relative to baseline, national defense receives a $36 billion increase in 2003. Let me just indicate, as you can see, homeland security gets an increase over the baseline, and, remember, baseline is last year's spending plus inflation. That is roughly what constitutes the baseline. The President's increase above the baseline for homeland security is $5 billion; national defense is increased $36 billion. This will throw some people because they are familiar with a $48 billion increase, but part of that is in the baseline. International Affairs, a $400 million increase; All Other Domestic spending, a $23 billion reduction.

Let's go to that next chart.

In terms of trying to kind of put in perspective how large our defense expenditure is, I think this chart is useful. It shows that under the President's plan we will be spending as much as the next 18 nations combined. Mr. Wolfowitz, when he was here, the Deputy Secretary, indicated we don't fight budget to budget. We fight adversaries. And he is exactly right.

But I do think it is important in terms of assessing and putting in context what this level of expenditure is that we understand where we fit in with the rest of the world.

And, of course, the increases that are being proposed don't just have an effect on 2003. They have an effect for the next decade. And we see the President's budget proposal over the decade is $656 billion over the baseline. That is an enormous amount of money. And we have to ask the tough questions with respect to that dedication of resources.

During this hearing, we hope to better understand the President's defense request. In particular, we will focus on the following questions:

One, does the budget make the right assumptions about the war on terrorism?

Two, does the budget take the right approach to military transformation?

And, three, is additional funding becoming the priority at the expense of real reform? This is a concern which was expressed by the former Vice Chairman of the Joint Chiefs of Staff, Admiral Owens, when the President's budget was released on February 4th. He said at that time, "A return to the defense spending heights of the mid-1980s is not necessary to win the war on terrorism or to transform our armed forces. In fact, it could be quite counterproductive. Availability of such large sums of money will reduce incentives to eliminate costly redundancies in our force structure 'tooth,' but particularly in the 'tail' of defense bureaucracy and support organizations. The truth is," continuing to quote Admiral Owens, "that we already have all the money for defense we need, so long as we undertake real reform and spent it better."

Let me just say I think we also need more money for defense. I don't think it is going to work if we try to use just the existing resources dedicated to defense. I think it is going to take more money.

But Admiral Owens does raise very serious questions about whether if we give this amount of money, do we, in effect, stop the process of reform and eliminating the duplication that we all know exists in the military. I have had top military leaders say to me, look, you do have to provide some skepticism here. It is important because we have very significant duplication because of the various branches of the military. And if we were any business, if we were any business in America, we would look at those places where we have redundancies and duplication. So much of it is in the administrative area, not in the warfighting capability but in the so-called tail, the administrative support. And I think we all know that is true.

With that, I am very pleased that our ranking member is here, and I would recognize him for any statement that he would like to make. Then we will go to the witnesses, and we would ask each of you to testify, and then we will open it up, as is our usual practice, for questions.

Welcome, Senator Domenici.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Thank you, Mr. Chairman. I will be very brief. If you will put my remarks in the record?

Chairman CONRAD. Sure.

Senator DOMENICI. I look forward to your testimony. I have been listening to budgets now for defense for 25 years, 26, as a member of this committee. For many of those I have been sitting in that chair or this chair. This is a very unique one because we have right in front of us we have a situation where the United States military presented us a budget for war. They were doing some transition work, and all of a sudden had a brand-new war that was unexpected, one that we are not used to, one that we didn't plan for.

Now this year we have the reality of this particular war on terrorism, which we can't quite grasp in terms of how long will it go on and how big will it get.

But I would assume it is realistic for all of us to anticipate that there might be some other engagement that we don't even contemplate during the next 12 months, 24 months, or 36 months. I would hope that we are not just preparing spending all this money for war on terrorists. I would assume we are preparing for other kinds of protection to the American people internationally.

Then we have added to it a brand-new set of defense criteria that are going to have to be applied to the Defense Department for homeland defense. Just as we prepared for the defense in an international sense away from our borders, clearly there are going to have to be some new use of the military here in the United States, preparing the United States for terrorism here, some of which could only be handled by defense people and some aspects that could only be handled with defense equipment.

So I look forward to your testimony. I say to the chairman, whatever numbers we choose, it is pretty obvious to this Senator that what is going to happen, defense is going to be getting an awful big increase as compared with many domestic programs. And one of the difficult things we are going to run into is how do we make sure the money is spent for defense and not something else. I think that is a very serious problem. I am willing to raise it early. There are a lot of people that don't think it is a problem. I think it is. When you give defense as big an increase as this and you are trying to hold many of the other departments to much lesser numbers, there have got to be some way that you can be assured that most of the defense money will go to defense. And I will share that with you in more detail as we progress.

Thank you for the time, and thank you for your time.

Chairman CONRAD. Thank you, Senator Domenici.

With that, let's turn to our witnesses, and we will start with Mr. Weston, again, a very distinguished business leader in our country, the former chief executive officer of Automatic Data Processing, a remarkable success story in our country, and vice chairman of the Business Executives for National Security, and co-chairman, as I indicated before, of the Tail to Tooth Commission. And, by the way, I have the document—one of the documents, really a package that the Tail to Tooth Commission produced. And this really is—I commend it to anybody listening. I certainly commend it to our colleagues—a lot of very thoughtful work went into the Tail to Tooth Commission—"Arming the Pentagon to Change Its Business Practices." I don't think there is a single member of this committee that doesn't know we have got to improve management of our defense establishment. Senator Grassley has been a leading advocate of this for many years. I think every member of this committee understands the need for reform.

With that, welcome, Mr. Weston, and please proceed.

STATEMENT OF JOSH H. WESTON, HONORARY CHAIRMAN, AUTOMATIC DATA PROCESSING, INC., VICE CHAIRMAN, BUSINESS EXECUTIVES FOR NATIONAL SECURITY AND CO-CHAIRMAN, BUSINESS EXECUTIVES FOR NATIONAL SECURITY TAIL-TO-TOOTH COMMISSION

Mr. WESTON. Thank you, Mr. Chairman, and I thank the committee for this opportunity. I also thank you for that unpaid commercial about the Tail to Tooth Commission.

I am here today in a couple of capacities, which you have already cited.

I might also add that my predecessor as CEO of ADP was one of your former colleagues, Frank Lautenberg. When he got elected to the Senate in 1982, that gave me the chance to become what I was.

First, as you cited, I am a vice chair of the Business Executives for National Security. We call it BENS for short, B-E-N-S. It is 20 years old. There are some 300 business executives with significant experience in our organization. We are absolutely nonpartisan, and our primary mission is to use our relevant experience to help the Pentagon improve its business practices and its management practices, which today govern over half of all the expenditures in the Pentagon.

BENS is not for more dollars. We are not for fewer defense dollars. We want to spend them better. We take no positions on strategies or weapons systems, and we are for effective planning and efficient implementation to provide appropriate national security. We must spend whatever it takes to defend our Nation, but I will add to that no likely amount will be adequate if we cannot spend our military dollars efficiently.

BENS has been well-received by senior Pentagon civilian and military leaders over the last four administrations, and although we haven't agreed on every issue, we think that relationship has been helpful. We have also had many useful exchanges with relevant congressional committees and their leaders.

In addition, BENS has been very deeply involved in promoting public-private partnerships to enhance homeland security. We did that well before September 11th, but that is not part of today's proceedings.

My second relevant hat, which the chairman has cited, was as co-chair, together with Warren Rudman, of the BENS Tail to Tooth Commission. And the Commission members in their various capacities included Sam Nunn, Bill Perry, Frank Carlucci, and many other well-known civilians and retired military. "Tail," as I am sure you deduced, stands in the military for overhead; "Tooth" means fighting forces. Almost 70 percent of DOD dollars are now spent on overhead and support functions. Any large organization does need logistics support. It does need infrastructure. But no well-run organization should be allocating up to 70 percent of its resources into overhead support. And to put it on a local basis, no local community would tolerate seven out of every ten police officers sitting behind desks while only three of them are out on the streets.

DOD is saddled with 20 to 25 percent excess capacity on our military bases. These are buildings that must be maintained, facilities that have to be guarded. That means using soldiers, sailors, and airmen who could be fighting a war on terrorism, instead supporting that excess capacity.

Nine hundred fifty thousand military and civilian workers perform activities that are commercial in nature at DOD—950,000—activities for which efficient providers can usually be found in what we call the Yellow Pages of the phone book.

The DOD logistics system currently spends over $80 billion a year, logistics, that is, employs over 1 million people on logistics, and still only achieves an average response time to fill a repair part requisition of 18 days. In the private sector you would look for 1 to 3 days.

And, finally, DOD over the next decade will have to try to keep track of about $4 trillion in spending, with a broken finance and accounting system that can't begin to produce an auditable financial statement.

In early 2001, Warren Rudman and I delivered and discussed our Tail to Tooth Call to Action with each of the incoming new service Secretaries and with their Deputies. Starting with Donald Rumsfeld and Pete Aldridge, every one of them enthusiastically endorsed our blueprints for action. Secretary Rumsfeld indicated so as recently as last September 10th. We need sharper teeth, and the tail is consuming grossly excessive resources, to the detriment of sharp teeth.

Our recommendations in that document that the Chairman held up were not called reports, because we don't need more reports. There have been 18 prior DOD commission or task force reports on this subject since the well-known Packard Commission in 1986. Their cumulative prior findings support our 11 blueprints for action that were in that packet. This Nation doesn't need reports. What we need is action. I will not recite the details in that packet, but I will be happy to answer any questions about it.

Prior to the September 11th tragedy, Secretary Rumsfeld and his senior colleagues were on a very aggressive course to use many of those BENS blueprints to redirect unnecessary and wasteful overhead resources into our fighting forces, where the teeth had many cavities.

Moving tail into tooth is culturally challenging. It intersects with entrenched bureaucracies, parochialism, politics, and vested interests. BENS believes that the determination and skills of the senior Pentagon leadership plus the prior discipline of a balanced Federal budget would have produced very salutary outcomes in strengthening our fighting forces. However, September 11th changed the military and the political climate. An easy-money approach and a sense of patriotism have very much distracted and loosened the financial and management discipline in national security, in both branches of Government. We rightfully shifted our primary focus to winning a war.

That war in Afghanistan recently proved that we can gain and maintain a huge new competitive edge by radically transforming our fighting forces with new technology, mobility, adaptability, and rapid, long-distance support. This requires big investments in new equipment and processes. This requires a much more agile logistics and support structure.

In the private sector, efficiencies, effectiveness, and organization improvements are continually mandated in a very compelling way by competition and by shareholder economic interests, neither of which operate in the Government.

There is a good way for Congress to restore and invigorate an appropriate continuing high-level pressure at the Pentagon to reduce overhead and redundancies. We recommend that the Congress determine and authorize appropriate increases in expenditures for the teeth of our fighting forces. The Nation needs and can afford the necessary expenditures to sharpen those teeth and sharpen our fighting capacity.

At the same time, we recommend to Congress that, in the upcoming budgeting process, you mandate a significant reduction in the Department of Defense's huge tail and mandate it for next year. The originally submitted budget leaves the bloated tail virtually intact and requests a relatively modest amount for good, new teeth. BENS thinks we probably will need even more allocation for tomorrow's competitive advantage in technology and agility.

We urge you to use your budgeting clout to force the Pentagon to shed some tail and even some obsolete teeth. You might authorize our very capable Secretary of Defense to implement changes in that bloated overhead in whichever ways he deems most effective and report back to you in that regard in the near future. If 70 percent of the DOD budget is tail, a mere 5 percent reduction in that tail could quickly save over $10 billion per year for better purposes. The future annual savings could be much greater. The Defense Science Board has estimated that $15 to $30 billion in savings is possible.

These cuts in overhead are possible even while we wage a war against terrorism. In that regard, to use a cliche, the Pentagon leadership can walk and chew gum at the same time.

I shift now to financial management. The Pentagon will spend on the order of $4 trillion in the next 10 years in thousands of programs for which there is really no effective financial oversight or control. There were 670 poorly connected major data systems that were required to produce the 2003 budget—670 poorly connected data systems. The current financial system does not permit effective decision-making or tracking or outcomes accountability. It makes good sense for Congress to mandate a 21st century activity-based accounting system under qualified civilian leadership, with funding to achieve that objective. Even if it takes several billion dollars up front to install a good financial system, the payback in financial management over the next $4 trillion of expenditure would be huge. Today, we are flying almost blind in this area of financial accountability.

Although your committee does not set the what's and the how's of how the Pentagon executes its much needed reformation in business and management, you can set the right tone with your budget mandate and with the message that you attach to your budget.

A democracy is not designed to primarily be an efficient engine. You leave that to the private sector. There is a certain unavoidable degree of managerial sloppiness in democracy. But our terrific Nation, with its many proven leaders, needn't permit the spirit and the skills of our fighting forces to be continually diluted and distracted by a most clumsy tail.

I conclude by observing that no matter how much money is spent on our defense, our Nation will not have the agile, innovative fighting forces it needs to prevent and/or win future wars without major changes in the way the Pentagon does business. Your budget message can be an important stimulus in that direction.

I thank you for this opportunity and would be pleased later on to answer your questions.

[The prepared statement of Mr. Weston follows:]

THE PREPARED STATEMENT OF JOSH S. WESTON, HONORARY CHAIRMAN, AUTOMATIC DATA PROCESSING, INC., VICE CHAIRMAN, BUSINESS EXECUTIVES FOR NATIONAL SECURITY AND CO-CHAIRMAN, BUSINESS EXECUTIVES FOR NATIONAL SECURITY TAIL-TO-TOOTH COMMISSION

Thank you for giving me this opportunity to share some timely and important views with you on next year's DoD budget and its underlying processes. I am the former, long-time CEO of Automatic Data Processing, a very large computer services company. Frank Lautenberg was my predecessor until he was elected to the Senate in 1982.

I'm here today in a dual capacity.

First, I am a vice chair of Business Executives for National Security (BENS). BENS is 20 years old. We are some 300 business executives. We are non-partisan, with a primary mission of using our relevant experience to help the Pentagon improve its business and management practices, which today govern over half of our military expenditures.

BENS is not for more or fewer defense dollars. We want to spend them better. We take no positions on strategy or weapons decisions. We are for effective planning and efficient implementation to provide appropriate national security. We must spend whatever it takes to defend our Nation, but no likely amount will be adequate if we cannot spend our military dollars efficiently.

BENS has been well-received by senior Pentagon civilian and military leaders of the last four administrations, although we haven't always agreed on every issue. We have also had useful exchanges with relevant congressional committees and their leaders.

In addition, BENS has been deeply involved in promoting public-private partnerships to enhance homeland security since well before 9/11, but that is not part of today's agenda.

My second relevant hat today is as co-chair, together with Warren Rudman, of the BENS Tail-to-Tooth Commission. The Commission's members, in various capacities, included Sam Nunn, Bill Perry, Frank Carlucci, and many other well-known civilians and retired military. Tail in the military means overhead and Tooth means fighting forces. Almost 70 percent of DoD dollars are spent on overhead and support functions. Any large organization needs logistics support and infrastructure, but no well-run organization should be allocating up to 70 percent of its resources to overhead support. No community would tolerate 7 out of every 10 police officers having desk jobs or logistics jobs.

- DoD is saddled with 20 to 25 percent excess capacity on our military bases—buildings that must be maintained and facilities that must be guarded by soldiers and sailors, airmen and Marines who could be fighting the war on terrorism.
- 950,000 military and civilian workers perform activities that are commercial in nature or not inherently governmental—activities for which efficient providers can usually be easily found in the yellow pages.
- The DoD logistics system spends over $80 billion per year, employs over one million people, and still only achieves an average response time to fill a repair part requisition of about 18 days, vs. 1–3 days in the private sector.
- And, finally, DoD will have to try to keep track of about $4 trillion in spending over the next 10 years with a broken finance and accounting system that cant begin to produce an auditable financial statement.

In early 2001, Warren Rudman and I delivered and discussed our Tail-Tooth Call to Action with each of the incoming new service secretaries and their deputies. Starting with Donald Rumsfeld and Pete Aldridge, each of them enthusiastically endorsed our blueprints for action. Secretary Rumsfeld indicated so as recently as last September 10th. We need sharper teeth, and the tail has consumed grossly excessive resources, to the detriment of sharp teeth.

Our recommendations were not called reports, because there have been 18 prior DoD commission or task force reports on this subject, since the well-known Packard Commission in 1986. Their cumulative prior findings support our eleven blueprints for action. The Nation does not need more reports. BENS has made available to your staff copies of the Tail-to-Tooth Commission action blueprints. I will not recite their details here.

Prior to the September 11th tragedy, Secretary Rumsfeld and his senior colleagues were on an aggressive course to use many of those BENS blueprints to redirect unnecessary and wasteful overhead resources into our fighting forces, where the teeth had many cavities.

Moving tail into tooth is culturally challenging as it intersects with entrenched bureaucracies, parochialism, politics, and vested interests. BENS believes that the determination and skills of the senior Pentagon leadership, plus the prior discipline of a balanced Federal budget would have produced very salutary outcomes in strengthening our fighting forces. September 11th changed the military and political climate. An easy money approach and a sense of patriotism have very much distracted and loosened financial and management discipline in national security, in both branches of government. We rightfully shifted our primary focus to winning a war.

The war in Afghanistan recently proved that we can gain and maintain a huge new competitive advantage by radically transforming our fighting forces with new technology, mobility, adaptability and rapid, long-distance support. This requires big investments in new equipment and processes. This requires a much more agile logistics and support structure.

In the private sector, efficiencies, effectiveness, and organization improvements are continually mandated in a very compelling way by competition and direct shareholder economic interests, neither of which operate in government.

There is a good way for Congress to restore and invigorate an appropriate continuing high-level pressure at the Pentagon to reduce overhead and redundancies. We recommend that Congress determine and authorize appropriate increases in expenditures for the teeth of our fighting forces. The Nation needs and can afford the necessary expenditures to sharpen our teeth and fighting capacities.

At the same time, we recommend to Congress that, in the upcoming budgeting process, you mandate a significant reduction in the DoD's huge tail next year. The originally submitted budget leaves the bloated tail virtually intact and requests a relatively modest amount for good, new teeth. BENS thinks we probably will need even more allocation for tomorrow's competitive advantage in technology and agility.

We urge you to use your budgeting clout to force the Pentagon to shed some tail and even some obsolete teeth. You might authorize our very capable Secretary of Defense to implement changes in our bloated overhead in whichever ways he deems most effective, and report back to you in that regard in the near future, If 70 percent of the DoD budget is in "tail," a mere 5 percent reduction in that tail could quickly save over $10 billion per year for better purposes. The future annual savings could be much greater the Defense Science Board said $15 to $30 billion in savings were possible.

These cuts are possible even while we wage a war against terrorism. In that regard, to use a cliche, the Pentagon leadership, can walk and chew gum at the same time.

I shift now to financial management. The Pentagon will spend on the order of $4 trillion in the next ten years in thousands of programs for which there is no really effective financial oversight and control. There were 670 poorly connected major data systems that were required to produce the 2003 budget. The current financial system does not permit effective decision-making, tracking, or outcomes accountability. It makes good sense for Congress to mandate a 21st century activity-based accounting system under qualified civilian leadership, with funding to achieve this objective. Even if it takes several billion dollars up-front to install a good financial system, the payback in financial management of the next $4 trillion would be huge. Today, we are often flying blind in this area.

Although your committee does not set the what's and the how's of the Pentagon's much needed reformation in business and management practices, you can set the right tone with your budget mandate and the message that you can attach to your budget.

A democracy is not designed to primarily be an efficient engine. There is a certain unavoidable degree of managerial sloppiness in any democracy. But our terrific nation, with its many proven leaders, needn't permit the spirit and skills of our fighting forces to be continually diluted and distracted by a most clumsy tail.

I conclude by observinq that no matter how much money is spent on our defense, *our Nation will not have the agile, innovative fighting forces it needs to prevent and/or win future wars without major changes in the way the Pentagon does business.* Your budget message can be an important stimulus in that direction.

I thank you again for this opportunity to comment. I would be pleased to answer your questions and/or to give examples of why BENS and many four-star officers agree that there's huge waste to be saved in the Pentagon's tail.

Chairman CONRAD. Thank you very much, Mr. Weston. We appreciate the effort that went into this testimony. It is really excellent. We appreciate it.

Dr. O'Hanlon, welcome. Please proceed with your testimony.

Let me just say once again that Dr. O'Hanlon's wife is expecting their first child, perhaps today. And so, Dr. O'Hanlon, if you have to rush off on very short notice, we will understand. Thank you so much for being here.

STATEMENT OF MICHAEL E. O'HANLON, SENIOR FELLOW, BROOKINGS INSTITUTE

Dr. O'HANLON. My wife cares enough about the future fiscal health and security of our country that she has decided to slow things down for the day. I appreciate very much the opportunity to be here. [Laughter.]

It is also a great honor, as a former CBO employee who worked for Senator Domenici and others in various capacities 10 years ago, to be before this committee. So I really appreciate the opportunity. I worked for Bob Reischauer in those early 1990 years.

I had a couple of broad thoughts before I try to construct sort of a brief alternative defense budget plan, and that is what I want to try to do in just 5 or 6 minutes with my testimony. But the broad thoughts, what I want to propose is that we do need additional defense spending increases, but I think roughly half as large as what is now in the administration's budget, and I will try to give a couple of details as to why I think that is about the right size, both for next year and then over the 5-year plan. I think the planned increases are roughly twice what is called for.

Before I get into those specifics, I think it is worth beginning with a sense of where we are. Two years ago, at Brookings, we did a fairly exhaustive study of the hot issue of military readiness because that establishes the baseline in terms of where the military is today, and I think gives context as to how much we need to add to improved readiness. We have heard a lot of criticism about the state of the military, and there certainly are a number of problems. But the broad point I would want to make to start with is that if you look at the overall state of the United States military in the late 1990s, it was actually what I would say was overall a B-plus. If the military readiness of the early 1990s was an A under President Bush 41, I think military readiness did decline a bit in the 1990s as we tried to downsize the force and handle a whole set of new missions. But I think overall the decline was exaggerated. There were a number of specific problems. Many of them were addressed by the Congress and by the administration in the late 1990s, and overall we were at a state of readiness that was roughly comparable to the typical levels in the Reagan years.

Now, I know that sounds a little surprising perhaps to some, and I would acknowledge that the morale of military personnel was not as good in the late 1990s as it was in the Reagan period. But the overall typical quality of equipment, the readiness of equipment, the number of spare parts available, the level of training, most of these quantitative metrics were comparable to mid-1980s levels. So I think we have to recognize the military had not been hollowed out in the late 1990s. There were a lot of strains. There still are strains, and they need to be addressed. There are some needs for plus-ups, but I think that important point needs to be put on the table.

Let me turn quickly to the 2003 budget, and here I have a couple of thoughts on sort of process more than on substance, before I get into my alternative long-term plan.

It seems to me in the 2003 budget, of the $46 or $48 billion increase that you were discussing earlier, Mr. Chairman, about $20 billion of that, of course, is for war-related costs. And I would propose those costs be pulled out of the budget and addressed separately as supplemental appropriations bills. I would have two main reasons for arguing that. One, of course, Congress' role in the process needs to be protected, and I don't believe that Congress should give a blank check, even in these times of national emergency, to the administration for possible wartime costs in 2003.

Secondly, I believe that we need to get the money that the troops require to them as soon as possible, and part of that $20 billion war-related cost request has to do with costs that have already been occurred or are being incurred right now. Why not consider that piece as part of the 2002 supplemental appropriations bill? This would have the added benefit of not inflating the 2003 defense baseline any more than necessary. I don't want to see that number artificially inflated myself because then every future year budget debate begins from a higher baseline. And it seems to me if we have war costs that are specific to this time of national crisis, we should identify them as such and put them into supplemental bills instead of implying that becomes the new baseline for future debate. So, therefore, I hope that that $20 billion of the 48 increase is pulled out and treated separately, perhaps some of it in the short term as part of the 2002 supplemental bill, and then the rest, if and when the money is needed for next year's military operations.

That is my broad thought on the 2003 defense bill. Let me turn now to more substantive issues and just go through four main points for the four main budget areas of military pay, military procurement, research and development, and, finally, operations and maintenance. I just have a couple of thoughts on each one, and I might as well start with the most controversial, which may make the other ideas somewhat less visible. But, nonetheless, my idea is that military pay is now in reasonably good shape in this country. It is a counterintuitive thing to say. It is certainly not being commonly voiced in this time of national crisis. But because of the efforts of the Clinton administration and the Congress—and I don't want to sound partisan in implying one was more important than the other, but in the 1990s, in the late years, we improved military pay and benefits a great deal in this country. And the idea we need to continually increase pay above and beyond not just the inflation rate but the employment cost index I think is incorrect.

I think CBO and Rand have done very convincing studies that the idea of a systematic military-civil pay gap is a myth. There is no such pay gap across the force. Most of our forces work in a very brave way, not for large financial compensation, but nonetheless, if you compare their compensation, broadly defined, including all their benefits, to the benefits of and compensation of people at comparable age and experience and education levels in the private sector, most military people are not underpaid today. And that is just the econometric truth.

Now, we may want to say that military people should be paid better because they are risking their lives, they are serving their country, and there is certainly a reasonable argument to be made along those lines. But I think people need to look back at the data and recognize that military pay today is in pretty good shape.

Therefore, I would concentrate pay on those specialties—future pay increases on those specialties where we are having a hard time recruiting and retaining, pilots, computer specialists, other technical specialists. These are the fields we still need more pay to have recruiting and retention be in good shape.

In general, we have solved a lot of the recruiting and retention problem in my judgment, and the numbers back me up. And I don't think that big across-the-board pay increases are necessarily required. So I would limit the pay increase to the rate of inflation for the next few years. There are additional benefits that are being conferred upon people in housing, in health care, so compensation overall is still going up above and beyond the rate of inflation. And, therefore, I don't think we need to burden the future budget as much as we now are with these increases.

Secondly, let me turn now briefly, Mr. Chairman, to operations and maintenance. This, of course, is the huge gorilla that we can never quite understand or get our arms around. It seems to have a life of its own. It seems very hard to limit this. There are a lot of reasons why. Mr. Weston, of course, has discussed many of these already. I won't try to add to his remarks. He understands this situation much better. But I would make a couple of additional comments.

One is that in the area of military health care we are going to add as much money as we have—add as much in the way of liabilities to the military health care system as we have. I think we have to think hard about reforming it and looking at that particular part of the operations and maintenance budget in very specific terms. We have four services that largely have their own infrastructures for military health care, much of their own administrative mechanisms. They don't really operate according to private sector principles, and I think we need to seriously reform the military health care system. It is primarily being sized and structured today for peacetime civil needs. And, therefore, we don't need to think in terms of this being primarily a deployable, mobile military health care system for combat. You need a certain piece of the system to be ready to do that. But most of the rest is treating retirees and family members and dependents and so forth, and it needs to be done more efficiently, according to more private sector principles. So this is a good time, as we are adding money to that account, it is a good time to look hard at military health care. I think the potential savings are $2 to $3 billion a year if you go to more market-oriented principles and consider a copayment requirement for people as well. That is my main comment on operations and maintenance.

Maybe one more point in the O&M budget. I think we need to find ways to give base commanders more incentives to look for reforms and look for efficiencies. Right now if they come up with an efficiency, it does them no good because they don't get the money or even a part of the money for their own local needs in general. We need to give them ways to benefit so that if they identify savings, they get to share in those savings for their local base needs. And I believe you will see a lot of the efficiencies being incentivized if you take that approach. But if you have an O&M budget that is going up at 2 and 3 and 4 percent a year in real terms, it allows people the impression they can sort of buy their way out of their problems. So I think that is a mistake to have such an ambitious projection for future O&M spending.

Research and development. We are all in favor of research and development. I think the Bush administration has a lot of good initiatives in this area. I support much of what it is trying to do with transformation because I think most of what you want to do with transformation today is in the research and development stage. I think in general there is not a lack of effort here. But I think there may actually be a little too much effort because the research and development budget wasn't cut that much in the 1990s. It was selectively protected as we cut procurement, and now it is being increased drastically. Mr. Bush already increased the R&D budget in his 2002 amendment or adjustment to the President Clinton budget he inherited, and now he wants to add $4 or $5 billion a year more. I think that is more than is necessary. R&D spending is already pretty robust in the 2002 budget, and further large increases of $4 or $5 billion a year I don't think are called from. I would propose a couple of specific ways in which you might make those savings. If you like, we can discuss that subsequently.

Finally, procurement. Of course, this is the long-term driver of the overall Pentagon request. Right now we are at about $60 billion a year. The 2003 budget would get us up to 70. The 2007 budget would get us up to about 100. And that may sound exorbitant, but, of course, those of us who read CBO studies know that even CBO acknowledges that if you keep the current plan, you probably have to spend almost that much money on a sustainable basis to buy all the F–22 and joint strike fighters and Virginia Class attack submarines and so forth that are in that plan. Therefore, I would propose a different plan. I would propose a different approach to modernization. Loren probably will have a different approach himself, but it may not be quite the same as mine, so let me quickly spell out what I would advocate.

I would advocate largely a silver-bullet force where, in other words, you buy modest numbers of the best technology. You buy modest numbers of F–22s, modest numbers of joint strike fighters, maybe 100 or 150 F–22s. Otherwise, you buy the kind of technology you already know how to produce. It is already the best in the world. It is getting better all the time because we can upgrade it, we can put better munitions and better sensors on these weapons. We are already in very, very good shape against any possible major-power foe. I would buy 150 F–22s as an insurance policy. I don't think we need them against the Iraqi or North Korean air force, maybe against the Chinese air force in 2020. But that is why 150 would be enough, essentially a one-way capability worth of F–22s. Otherwise, you keep buying weapons like F–15s and F–16s that you know how to buy.

Another example, the V22 Osprey. Assuming that the Marine Corps can solve the safety problem that tragically claimed some 23 lives in the last couple of years, if the Marines can solve that problem, I would advocate buying a modest number of V22s for special-purpose commando raids, for the kinds of things we might have wanted to do in Afghanistan if we had ever found actionable intelligence on Osama bin Laden, but not for the entire Marine Corps amphibious capability. I would otherwise continue to buy helicopters. We can buy those. They are better than the ones we already have. We can buy them more quickly. We can buy them in a way that keeps the Marines safe because we can get those helicopters into the Marines' hands quickly instead of holding out all of our hope for the V22, which may or may not turn out to be safe, may or may not turn out to be affordable. And so, again, I would buy a modest number of these kinds of capabilities and not imply that we have to do a systematic procurement modernization of the best technology across the board.

I would take advantage of the electronics and computer revolutions and buy the better munitions like JDAM, the better reconnaissance capabilities like the unmanned aerial vehicles we have seen in Operation Enduring Freedom and try to focus our efforts on these systems. They are not that cheap, but they are not as expensive as F–22s and V22s and joint strike fighters.

So if you put all this together, just to summarize, Mr. Chairman, I think you have a procurement budget of perhaps $80 billion you would have to ultimately reach, and I would acknowledge the need for further increases. I think military pay has to keep going up with inflation, but not much more than that. I think research and development should be sustained at its current real level, but it doesn't have to go up much above where it is now in the 2002 budget. And the O&M budget is still going to keep pushing up no matter how hard we try, but we have to find some ways to incentivize people to do what my colleague has suggested and try to reform that budget and make it more economical.

Even if you do all that, you still wind up with real defense budgets that go up, and I think next year you have to spend $370 billion on defense, and in 2007 you will be up to $430 billion, even under my plan. But I think that would still leave a savings of ultimately about $40 to $50 billion a year relative to where the President is now headed.

Thank you, Mr. Chairman.

[The prepared statement of Dr. O'Hanlon follows:]

PREPARED STATEMENT OF MICHAEL O'HANLON, SENIOR FELLOW, BROOKINGS INSTITUTION

In proposing a $48 billion defense budget increase for 2003 following a large increase in 2002, President George W. Bush has followed in the budgetary footsteps of former President Ronald Reagan and Reagan's defense secretary, Caspar Weinberger. Adjusted for inflation, Bush's 2003 defense budget would be $50 billion higher than the 2001 budget. By 2007, the real dollar defense budget would go up $30 billion more, approaching the peak levels of the Reagan years.

Even in these troubled times, such increases are too much. Further defense budget growth is needed. But the Pentagon needs to be more selective about its weapons modernization plans. In addition, after several successive years of increases, military pay is now in fairly good shape, as reflected in the improved statistics for recruiting and retaining personnel in recent times. America's military men and women are of outstanding caliber and deserve proper compensation, but their pay is no longer poor compared with private sector employment, and the Administration's plans for large increases are excessive. The large research and development budgets proposed by the Administration exceed the already hefty increases advocated by President Bush during his campaign; given that research and development was not severely cut during the 1990s, such growth seems unnecessary now. Finally, the Pentagon also needs to reform many of the ways it provides basic services such as military health care, military housing, and various base operations. Unfortunately, if budgets get too big, the Pentagon's incentives to look for efficiencies are likely to weaken. On balance, the planned increases in defense spending are roughly twice as much as would be appropriate in the years ahead. Instead of the Administration's plan for a $396 billion defense budget in 2003, which would increase to $470 billion by 2007, next year's budget should be about $370 billion and the 2007 level should not exceed $430 billion.

The Bush Administration's Proposed Defense Budget

The Bush administration's fiscal 2003 budget request for the Pentagon fleshes out the budgetary details of Secretary of Defense Donald Rumsfeld's Quadrennial Defense Review (QDR), released last September 30. That QDR was a cautious document on the whole. While it unveiled several new initiatives, they were largely conceptual ones. The QDR increased the military's emphasis on homeland security. Relative to the Clinton defense plan, it also adopted a somewhat less demanding type of two-war scenario as the proper standard for sizing American armed forces. In addition, and more concretely, it placed greater emphasis on missile defense, defense research and development, and joint-service training and experimentation.

But otherwise, the QDR essentially reaffirmed the Clinton administration's weapons modernization agenda and force structure retaining about 1.4 million active-duty troops, ten active-duty army divisions, three active-duty marine divisions, twelve aircraft carrier battle groups, about fifty attack submarines, and roughly twenty tactical fighter wings, as well as about 250,000 active personnel deployed or stationed abroad. After rampant early speculation that overseas troop deployments would be reduced, a generation of weapons programs would be skipped, and the size of the United States ground forces would be curtailed significantly, Rumsfeld's defense plan proved far more cautious and far more consistent with that of his predecessors.

The September review was silent, however, on the question of costs. Now we have the bill for this defense plan, and that is where the big changes arise. The Clinton administration's national security budget had grown to about $300 billion a year by 2001 (including about $15 billion in annual funding for nuclear weapons activities at the Department of Energy). Incorporating the effects of September 11 and Operation Enduring Freedom in Afghanistan, President Bush's budgets are flow as follows: $329 billion in 2001, $351 billion in 2002, and $396 billion proposed for next year. Breakdowns of the Pentagon's part of these budgets are shown in table 1.

Table 1: Department of Defense Discretionary Budget Authority
(In billions of dollars)

Budget Category	2002 Estimate	2003 Estimate
Military Personnel	82.0	94.3
Operations and Maintenance	127.7	150.4
Procurement	61.1	68.7
RDT&E	48.4	53.9
Military Construction	6.5	4.8
Family Housing	4.1	4.2
Other	4.5	3.0
Total Discretionary Budget Authority (not including Department of Energy)	334.3	379.3

Source: Department of Defense, "FY 2003 Defense Budget," February 2002

Equally striking, however, are the price tags envisioned for the years ahead: $405 billion (2004), $426 billion (2005), $447 billion (2006), and $470 billion (2007). Congress will not act on those budget plans this year, but they show where the Bush administration's budgets are headed if they are approved by Congress—toward a period of very high defense spending.

In a sense, the increases are not quite as great as they seem. The figures for 2001–2003 include the costs of the anti-terrorism war; all the figures include funding for the Department of Defense's heightened vigilance and contributions to homeland security after September 11. These combined costs are now running about $30 billion a year. Moreover, due to the effects of inflation, the $470 billion budget for 2007 represents about $425 billion when expressed in 2002 dollars. And compared to the size of the United States economy, these budgets would still reflect a smaller fraction of Gross Domestic Product (GDP)—about 3.5 percent—than at any time during the cold war.

Still, despite these factors, the increases are remarkable. The Pentagon's budget in 2007 would be a full $100 billion greater than what the Clinton administration had envisioned for that year in its own long-term plan. And as noted, these figures would approach the peak levels of the Reagan years, as well as those of the Vietnam era.

Why does President Bush wish to restore defense spending to such high levels? He does not plan to increase the size of the military, which remains one-third smaller than in cold war times. Moreover, with the exception of missile defense, Bush administration officials have not yet added any major weapons systems to the modernization plan they inherited from their predecessors. Instead, the Bush administration claims that in general it is only fully funding the force structure and weapons procurement agenda that was laid out in Secretary of Defense William Cohen's 1997 Quadrennial Defense Review, as well as the immediate exigencies of the war on terrorism. This argument can be seen explicitly in the Pentagon's breakdown of the proposed increase in the 2003 defense budget (see table 2).

Table 2: Understanding the Increases in 2003 Defense Budget Proposal
(Funding for the Department of Defense only, in billions of dollars)

Enacted Budget for 2002	331.2
Upward Adjustment for Inflation	6.7
"Must Pay" Bills	
Over-65 health care	8.1
Civilian retirement/health care	3.3
Military and civilian pay raises	2.7
(Subtotal)	(14.1)
Realistic Costing	
Realistic Weapons Costing	3.7
Readiness Funding	3.1
Depot Maintenance	0.6
(Subtotal)	(7.4)
Cost of War (including $10 billion contingency fund)	19.4
All Other Requirements (e.g., Weapons Acquisition)	9.8
Savings from Transfers and Program Cuts, Delays	-9.3
Total 2003 Budget Request	**379.3**

Source: Department of Defense, "FY 2003 Defense Budget," February 2002

The main point that the Bush administration wishes to make with this table is that most of the $48 billion added between 2002 and 2003 is effectively beyond the control of a scrupulous bookkeeper, given the obligations inherited from the Clinton administration and the Congress as well as the demands of war. The Bush administration is essentially arguing that $36.6 billion of the increase is automatic, and another $10 billion is simply a conservative estimate of what next year s military operations will entail. Indeed, were it not for the $9.3 billion in program cuts, postponements, and accounting changes the Bush administration managed to make, virtually no money would be left for other purposes such as increased weapons acquisition. Even the $9.8 billion added for weapons will fund a plan for fighter jets, ships, Army transformation, and other advanced systems that was primarily inherited from Clinton administration.

For those who doubt the need for added defense spending, it is further true that a military of a given size costs more to maintain each year. Whether it is the price of weaponry, the burden of providing military health care to active-duty troops and their families as well as to retirees, or the price of paying good people enough to retain them, most defense costs rise faster than inflation. Moreover, the United States military took a "procurement holiday" of sorts during the 1990s, since money was tight and since it had so much modern weaponry on hand after the Reagan buildup. That holiday must now end, as systems age and require refurbishing or replacing.

In addition, the lessons of Operation Enduring Freedom need to be built upon. That conflict has demonstrated, more than any other before, the importance of unmanned aerial vehicles, real-time information networks, certain precision munitions, and good equipment for special operations forces. These and most other "transformation" initiatives proposed by the Bush administration merit support (see table 3).

Because of these various factors, real defense spending should indeed continue to increase, as it has been doing since 1999. It makes perfect sense that today's military, though only two-thirds the size of the cold war force, might cost nearly as much. What is surprising, however, is that the Bush budget would not only reach but easily exceed the cold war defense budget average.

Table 3: Desirable "Transformation" Initiatives in 2003 Budget Proposal
(In millions of dollars)

Convert 4 ballistic-missile submarines to cruise missiles	1,018
Add funding for new satellite communication system	826
Add funding for space-based radar	43
Add funding for Global Hawk unmanned aerial vehicles (UAVs)	629
Accelerate development of new UAVs	141
Upgrade, arm, and purchase more Predator UAVs	158
Develop small-diameter bomb	54
Initiate Navy unmanned underwater vehicle	83
Start new program for advanced surface combatant technologies	961
Expand wideband, secure global communications network	1,300
Upgrade data links to combat platforms, troops	3,300

Source: Department of Defense, "FY 2003 Defense Budget," February 2002

An Alternative to the Bush Strategy and Budget

It is true that the 1997 QDR, developed during a period of fiscal restraint, did not provide enough funds for its own proposed plan. But Congress and the Clinton administration later added more than $20 billion to the annual real dollar budget, and Secretary Rumsfeld added another $20 billion for 2002 without counting added costs due to September 11. So the yearly baseline has already grown by $40 billion even as the plan for forces and weapons has remained mostly unchanged. Secretary Rumsfeld and President Bush now tell us that is still not enough. Alleging a decade of neglect, they claim that further spending increases are needed for military pay, readiness, infrastructure, health care, research and development, and weapons procurement. Overall, the Bush administration proposes to add a total of more than $400 billion from 2002 to 2007. It is true that each of the main Pentagon budget accounts still needs more funding. But the needs are not sufficient to require such large increases.

Before examining each major defense account individually, there is the matter of war costs to address. The Bush administration has requested almost $20 billion for such costs in the 2003 budget—$10 billion as its best guess of the cost of military operations that year, and $9.4 billion primarily to replenish weaponry and spare parts inventories and otherwise recuperate from the effects of the war on terrorism to date. However, to ensure transparency and to protect Congress's role in the budget process, these costs should be added to the supplemental appropriations bill now being prepared by the Administration for 2002 rather than added to the overall defense budget for 2003. Making them supplemental appropriations will also avoid artificially inflating the defense budget for 2003 in a way that would make defense increases in future years look smaller than they really are.

Pay. After the largesse of the last few years, military pay has never been higher in inflation adjusted dollars. Partly as a result, recruiting and retention have improved markedly in recent years.

Most additional increases should be targeted at those few technical specialties where the Pentagon still has trouble attracting and keeping people, rather than the entire force. In that regard, the Bush administration's plan to add a total of $82 billion to military pay over the 2002–2007 period is excessive. Since troops are receiving improved housing and health benefits at present, further pay raises should be held to no more than the rate of inflation. Over the 2003–2007 period, this approach would save about $30 billion relative to the Bush administration's plan (individuals would still get additional raises as they were promoted, of course).

In addition, another $5 billion could be saved through 2007 by modestly reducing the number of individuals in the military. Generally speaking, this should not be done by cutting the number of maj or combat units below current levels, but rather by making some of them slightly smaller in recognition of the enhanced capabilities of modern weaponry—as well as the need for a lighter and more deployable force.

Operations and Maintenance. This part of the budget funds a wide array of defense activities related to so-called military readiness, including training, equipment repair, fuel, and other necessities for overseas deployments, and most spare parts purchases. It also funds the salaries and health care of civilian employees of the Department of Defense. Even though readiness funding per troop is at its highest real dollar level ever, the Bush administration proposes adding $146 billion to this budget over the 2002–2007 period.

But reform in military health care could save $15 billion over that period, if ideas proposed in the past by the Congressional Budget Office (CBO)—including merging the independent health institutions of each military service, employing market-based care wherever possible, and considering introduction of a small co-pay for military personnel—were adopted. At a time when Congress has legislated a huge increase in the defense health budget by mandating free lifetime care for retirees, reform is all the more important.

In addition, giving incentives to local base commanders to find efficiencies in their operations might help limit real cost growth to 2 percent rather than 2.5 to 3 percent a year in other parts of the budget, saving $10 billion more.

Research and Development. President Bush has rightly emphasized research and development ever since he began running for president, but again, the 2002 budget already added large sums to this area. Current real spending on research, development, testing, and evaluation already exceeds the levels of his father's administration and roughly equals those of the peak Reagan years. No more than another $1 billion is needed for the 2003 budget and beyond. For example, economies should be possible by canceling one or two major weapons, slowing the army s future combat system until underlying technologies are more promising, and slowing at least one or two missile defense programs out of the eight now under way (while modestly increasing research and development on a national cruise missile defense).

Rather than add $99 billion to the pre-existing plan, about $55 billion should suffice for 2002–2007 (reflecting primarily the increases in the 2002 budget that would be sustained thereafter).

Procurement. The Clinton administration spent an average of about $50 billion per year to buy equipment; the figure is now about $60 billion. According to CBO, however, the expensive modernization plans of the military services might imply an annual funding requirement of $90 billion or more, Accordingly, the Bush-Rumsfeld budget envisions procurement funding of $99 billion in 2007.

But Operation Enduring Freedom has underscored the potential of relatively low-cost systems, such as Global Positioning System (GPS) guidance kits added to "dumb bombs," unmanned aerial vehicles (which cost a fraction of what manned fighters do), and real-time data links between various sensors and weapons platforms.

To be sure, expensive weapons such as aircraft carriers have been used as well. Moreover, not every future foe will be as militarily unsophisticated as the Taliban and al Qaeda. That said, the services need to prioritize. They should recognize, as former Vice Chairman of the Joint Chiefs of Staff Bill Owens has argued, that the electronics and computer revolutions often promise major advances in military capability without inordinate expenditures of money.

The current procurement budget of about $60 billion does need to rise to the $70 billion level proposed for 2003; in fact, it probably needs to reach $75 billion or higher. But the $99 billion level envisioned for 2007 is greatly excessive.

For many critics, the problem with Rumsfeld and Bush's weapons plan is that it protects the traditional priorities of the military services without seeking a radical transformation of the United States armed forces. But this basic criticism is not quite right. Individual programs or omissions in the Bush plan can be debated, but it is beyond serious doubt that the Bush administration has an aggressive program for so-called defense transformation (see table 3). As is appropriate for such an effort, most of the emphasis is in the realms of research, development, and experimentation, where the Administration envisions spending $99 billion more than the Clinton administration would have by 2007 (even though, as noted, these areas of the defense budget were not severely cut in the 1990s). The problem is a more classic one of unwillingness to set priorities. Despite the absence of a superpower challenger, the Administration proposes replacing most major combat systems of the United States military with systems costing twice as much—and doing so throughout the force structure.

A more prudent modernization agenda would begin by canceling at least one or two major weapons, such as the Army's Crusader artillery system. In addition, rather than replace most major weapons platforms with systems often costing twice as much, the Pentagon would only equip a modest fraction of the force with the most sophisticated and expensive weaponry. That high-end or "silver bullet" force, as CBO has described it, would be a hedge against possible developments such as a rapidly modernizing Chinese military. Otherwise, the rest of the force would be equipped primarily with relatively inexpensive upgrades of existing weaponry carrying better sensors, munitions, computers, and communications systems. For example, rather than purchase some 3,000 joint strike fighters, the military would buy about 1,000, and otherwise purchase planes such as new F–16 Block 60 aircraft (and perhaps even some unmanned combat aerial vehicles in a few years) to fill out its force structure.

Conclusion

In times of war, it is often militarily necessary, and politically natural, for defense spending to rise. But the nation is presently running the risk of spending too much on defense. Many members of Congress are fearful of challenging a popular president in a time of war over his proposed defense requests.

This dynamic puts the Nation's fiscal health and domestic agenda at risk and may not even be good for national security. Defense budgets may decline in the years ahead, especially as the Nation moves farther away from September 11. If that happens, the Bush administration may then regret that it sacrificed its opportunity to promote the kind of defense reform it championed on the campaign trail and during its first few months in office. The country could be left with a defense program that is too large and expensive for the resources at hand.

Some defense spending increases, beyond those already put in place since 1999, are needed. But most of those proposed by the Bush administration have only limited relevance to the war on terrorism. They should not be justified on the grounds of fighting al Qaeda, other terrorist organizations, or state sponsors of terrorism. And many are not needed on other grounds, either. The $48 billion increase requested for 2003 should be cut to about $20 billion, mostly because war costs should be paid through supplemental appropriations so that they are more visible and more easily debated by the Congress. And future defense budgets should grow by less than $10 billion a year above the inflation rate, winding up at $430 billion in 2007, rather than the $470 billion level proposed by the Administration.

President Bush, Vice President Cheney, and Secretary Rumsfeld all have considerable experience in the private sector. Yet they seem to be ignoring an important principle of corporate management—institutions need incentives to become more efficient. Give an organization all it wants and it will fail to prioritize; impose some financial discipline and it will innovate and reform.

Chairman CONRAD. Thank you very much. Thank you for that thoughtful testimony.

Dr. Thompson, welcome. Very good to have you here. We appreciate your taking the time to join the committee. Please proceed with your testimony.

STATEMENT OF LOREN B. THOMPSON, PhD., CEO, LEXINGTON INSTITUTION; ADJUNCT PROFESSOR, GEORGETOWN UNIVERSITY

Dr. THOMPSON. Thank you for inviting me, Mr. Chairman. I would like to spend about 5 minutes this morning talking about three things: the size of the defense budget, the priorities it reflects, and what I think is its principal defect, which is a dearth of procurement spending relative to need.

Concerning size, much has been made of the fact that at $379 billion, the proposed budget for 2003 would roughly match the combined spending of the 15 next biggest military powers. If you then add in the Department of Energy security programs, as you did in your chart, then it is the 18 next biggest.

Just the proposed increase between 2002 and 2003, or $48 billion, is as much as the entire military budget of Russia or China.

However, as a share of national wealth, the proposed budget is much lower than the norm for the last two generations, despite the fact that we have launched a global campaign against counterterrorism.

Between 1950 and the year 2000, defense spending averaged about 7 percent of gross domestic product annually. If GDP in 2003 surpasses $11 trillion, as expected, then the administration's defense budget would represent about 3.3 percent of the economy, less than half the average of the last 50 years.

Of course, the economy has grown considerably during that period. But if we consider the overall scale of the economy today, the proposed level of defense spending is actually relatively modest.

For example, it has been estimated by Standard & Poor's that Americans spend 6 percent of gross domestic product on gambling. If you believe that estimate, then the entire $6 billion shipbuilding proposal for fiscal year 2003 is about as much as we spend in one weekend on gambling.

Concerning priorities, the Bush administration has added substantial funding to several areas of defense activity that it considers to be underfunded, most notably military pay and benefits, training, equipment maintenance, and scientific research.

However, because the increases it proposes are spread across the entire defense budget, the priority assigned to major categories of activities has changed quite little since the Clinton years.

In the year 2000, the Clinton administration spent 26 percent of the defense budget on military personnel. Bush would spend 25 percent in 2003, 26 percent in 2005. In 2000, the Clinton administration spent 14 percent of the defense budget on research and development. Bush would spend the same percentage in 2003, 15 percent in 2005.

There is a similar alignment across time in the shares allocated to procurement and to operations and maintenance.

So while the Bush administration would raise the buying power of the defense budget considerably higher in 2003 than what prevailed in 2000—by about a third, actually—the alignment of priorities within the budget has changed relatively little from the Clinton years.

That is a very different situation from the fiscal year 1978 budget that Secretary Rumsfeld proposed when he was last in charge of the Pentagon. The 1978 budget was designed to reverse the post-Vietnam malaise in military spending by raising Pentagon funding above $100 billion for the first time in history. But back then, Secretary Rumsfeld stressed the importance of allocating a disproportionate share of the increase to investment accounts, an emphasis that is not at all apparent in the 2003 proposal.

While the Bush administration makes much of its desire to transform the military by embracing new technologies that enable new concepts of operation, its basic framework of ideas and programs for modernizing the military is quite similar to that of the Clinton administration.

Where it is different is in its willingness to allocate more money to all facets of military activity, which at least in theory accelerates the potential speed with which transformation can occur.

Even with the increases it proposes, though, a combination of rising costs, political constraints, and new overseas commitments has diminished the latitude Mr. Rumsfeld and his team have for radical innovation.

Finally, concerning defects, I think that the administration's defense proposal contains relatively few. It has corrected shortfalls in military pay and benefits. It has raised funding for readiness accounts. It has covered the Pentagon's share of the cost for the war on terrorism. And it has increased research and development funding for transformational technologies.

The one area where the budget is deficient is in procurement—in the replacement of aging weapons.

The Joint Chiefs of Staff estimate that $105 billion in procurement spending is needed every year in order simply to prevent the existing force structure from aging or shrinking.

The administration's proposed budget for 2003 only funds two-thirds of that amount, and thus it assures that an increasingly decrepit arsenal is going to grow older or smaller.

The shortfall in procurement is not new. In the Clinton years, we saw the only prolonged period in the last half-century in which procurement spending was consistently below 20 percent of the defense budget.

One consequence of that was that the average age of Air Force aircraft was 13 years in 1990 and 22 years today. The average

Navy plane today, for the first time in history, is older than the average Navy warship.

Some Army and Marine helicopters have become so aged that they pose a danger both to the readiness and to the safety of the people who are flying them.

I was sitting at dinner last night next to a four-star Marine general who told me that they are flying 35-year-old helicopters in Afghanistan. I don't think you could even get the FAA to certify a 35-year-old helicopter to fly civilians.

I have attached a chart to my remarks showing that every category of Air Force aircraft except bombers has either exceeded its maximum acceptable average age or is within months of doing so.

Because air power is essential to every facet of our warfighting effectiveness, I believe the defense budget needs to reflect a greater sense of urgency about replacing aging aircraft.

Aside from that shortfall in procurement, though, I believe the administration has done a fairly good job in its first year of balancing the Pentagon's books, fixing inherited problems, and addressing new dangers.

Thank you.

[The prepared statement of Dr. Thompson follows:]

PREPARED STATEMENT OF LOREN B. THOMPSON, PH.D, CEO, LEXINGTON INSTITUTE, ADJUNCT PROFESSOR, GEORGETOWN UNIVERSITY

Mr. Chairman and members of the Committee, thank you for inviting me to comment on the Bush administration's proposed defense budget for fiscal 2003.

This morning, I want to briefly discuss three subjects: the size of the defense budget, the priorities it reflects, and its principal defect—inadequate spending for procurement.

Concerning size, much has been made of the fact that at $379 billion, the proposed budget for 2003 would roughly match the combined spending of the 15 next-biggest military powers.

Just the proposed increase between 2002 and 2003—$48 billion—is as much as the entire military budget of Russia or China.

However, as a share of national wealth, the proposed budget is much lower than the norm over the last two generations—despite the fact that we have embarked on a global campaign to counter terrorism.

Between 1950 and the year 2000, defense spending averaged about 7 percent of gross domestic product annually.

If GDP in 2003 surpasses $11 trillion as expected, then the administration's defense budget would represent about 3.3 percent of the economy—less than half the average of the last 50 years.

Of course, the economy has grown considerably during that period.

But if we consider the overall scale of the economy today, the proposed level of defense spending is relatively modest.

For example, it has been estimated that Americans devote 6 percent of GDP to gambling.

At that rate, the Navy's proposed $6 billion shipbuilding budget for 2003 would be about equal to what is spent on gambling each weekend.

Concerning priorities, the Bush administration has added substantial funding to several areas of defense activity that it considered to be underfunded, most notably military pay and benefits, training, equipment maintenance, and scientific research.

However, because the increases it proposes are spread across the entire defense budget, the priority assigned to major categories of activity has changed little since the Clinton years.

In the year 2000, the Clinton administration spent 26 percent of the defense budget on military personnel; Bush would spend 25 percent in 2003 and 26 percent in 2005.

In 2000, the Clinton administration spent 14 percent of the defense budget on research and development; Bush would spend the same percentage in 2003 and 15 percent in 2005.

There is similar alignment across time in the shares allocated to procurement, and to operations and maintenance.

So while the Bush administration would raise the buying power of the defense budget considerably higher in 2003 than what prevailed in the year 2000—in fact, by nearly a third—the alignment of priorities within the budget has changed little.

That is a very different situation from the fiscal 1978 defense budget that Secretary Rumsfeld proposed when he was last in charge of the Pentagon.

The 1978 budget was designed to reverse the post–Vietnam malaise in military spending by raising Pentagon funding above $100 billion for the first time in history.

But back then, Secretary Rumsfeld stressed the importance of allocating a disproportionate share of the increase to investment accounts, an emphasis that is not apparent in the 2003 budget.

While the Bush administration has made much of its desire to "transform" the military by embracing technologies that enable new concepts of operation, its basic framework of ideas and programs for modernizing the military is similar to that of the Clinton administration.

Where it is different is in its willingness to allocate more money to all facets of military activity, which potentially accelerates the speed at which transformation can occur.

Even with the increases it proposes, though, a combination of rising costs, political constraints, and new overseas commitments has diminished the latitude Mr. Rumsfeld and his team have for radical innovation.

Concerning defects, I think the Administration's defense budget contains relatively few.

It has corrected shortfalls in military pay and benefits, raised funding for readiness accounts, covered the Pentagon's share of the cost for the war on terrorism, and increased research and development funding for transformational technologies.

The one area where the budget is deficient is procurement—the replacement of aging weapons.

The Joint Chiefs of Staff estimate that $105 billion in procurement funding is needed each year to prevent the existing force structure from shrinking or aging.

The Administration's proposed budget for 2003 only funds two-thirds of that amount, and thus assures that an increasingly decrepit arsenal will continue aging.

The shortfall in procurement is not new: the Clinton years were the only period during the last half century when procurement spending was consistently less than 20 percent of the defense budget.

One consequence was that the average age of Air Force aircraft rose from 13 years in 1990 to 22 years today.

The average Navy plane today, for the first time in history, is older than the average warship.

Some Army and Marine helicopters have become so aged that they pose a danger to both the readiness and the safety of United States forces.

I've attached a chart to my remarks showing that every category of Air Force aircraft except bombers has either exceeded its maximum acceptable average age or is within months of doing so.

Aging Aircraft

- **As aircraft age, they become less safe and more expensive to maintain.**

USAF Aircraft Age in Years			
	Maximum Safe Operating Age	Maximum Acceptable Average	Average Age Today
Fighters	30	15	14
Bombers	60	30	25
Electronic	50	25	24
Tankers	60	30	37
Intratheater Lift	50	25	23
Intertheater Lift	50	25	24

- **Average age of Navy aircraft exceeds that of ships.**
- **Army & Marines operate many Vietnam-vintage helicopters.**

Because air power is essential to every facet of our warfighting effectiveness, I believe the defense budget needs to reflect a greater sense of urgency about replacing aging aircraft.

Aside from the shortfall in procurement spending, though, I believe the Administration has done a good job in its first year of balancing the Pentagon's books, fixing inherited problems, and responding to new dangers.

Chairman CONRAD. Thank you very much, Dr. Thompson, for that testimony, and we appreciate again very much your being here, as well as the other witnesses.

I would like to go back to this fundamental question of tooth to tail, how much warfighting capability, how much overhead we have. Admiral Owens, who I have high regard for, former Vice Chairman of the Joint Chiefs, who happens to be from my hometown—we are very close friends—has told me repeatedly—he is a former nuclear submarine commander—before he worked his way up the chain of command, he was deeply involved in the move towards technology and jointness in the military, perhaps the foremost advocate for it when he was Vice Chairman of the Joint Chiefs of Staff. He has said to me over and over, Kent, you have got to look at tooth-to-tail question. We are spending too much—we are spending too much in the tail and not enough in the tooth.

Let me go to your analysis, Mr. Weston, in your testimony that 70 percent of the spending is in the tail, in administration. One of the things that testimony before the Budget Committee identified last year was in four areas we have tremendous duplication: medical, logistics, intelligence, and long-haul communications.

In your analysis on the work of the commission, can you tell us what is the basis for this 70 percent is in administrative overhead, in the so-called tail, versus less than 30 percent in the tooth?

Mr. WESTON. Yes. Those are not our numbers. We got them from Government sources. The GAO has looked at it, and they came up with a number that the Department of Defense also reviewed. They said 60 percent, but they excluded and identified certain things that you would also call tail, and if you put those onto their 60, it adds up to 70.

Just as another totally different index, the Defense Science Board took a look at how many combat-coded positions there are in the military. At that time they looked at it, only 16 percent of the total workforce in DOD was combat-coded positions. That means one out of six people are in combat-coded positions. The rest are one form of infrastructure, overhead, et cetera.

I don't think the issue is splitting hairs over whether it is 70 percent. Bill Owens would probably say it is higher than 70 percent. Someone else might pick a number of 67 percent. Any way you look at it, because of the redundancies you cited, the multiple silos, the tiering of the structure, so many tiers of supervision that have produced this seeming absurdity of one fighter backed up by five other people, any way you look at it—it doesn't matter whether you pick the number 70 percent—it is crying out for reform. And although I am not a Senator, I think you have two jobs here for the price of one. You have got to set a budget for next year. But I think also you have the very important opportunity to set a trajectory and a way of looking at things for many years into the future.

We, in my opinion, have a terrific set of very experienced civilian Secretaries. Because of the Tail and Tooth Commission I met every one of them, and their Deputies. They have the experience. They have the ability. I think what they need is the directional encouragement to do what they know has to be done, tackle that tail and start making changes.

Just to give you one other frame of reference, during the Vietnam period, it was estimated the tail-to-tooth ratio was 50/50. The difference between 50/50 and 70/30 would make available for teeth and other purposeful things $50 to $60 billion that is being used in overhead. It is just there if the determination is set at the senior capable civilian levels in the Pentagon to go after it while you are fighting the war instead of letting the war become an excuse to let all this other stuff stay.

I think the budget as submitted to you was business as usual. I would hope that this committee and the other relevant committees in the Senate decide that it is not the right time to just go business as usual.

Chairman CONRAD. Dr. Thompson, what part of that analysis would you disagree with in terms of this tooth-to-tail concept?

Mr. THOMPSON. Mr. Chairman, I think it is not so much what I heard that I disagree with as I would like to make a comment about what was left out. I spend a lot of time dealing with senior military officers, and they will tell you that, yes, they are wasting money. But then they will go on to tell you most of the reason they are wasting money is because of things that have been mandated by Congress.

A senior Air Force officer told me two days ago that he doesn't need 25 percent of his bases, but he doesn't believe he can close them going through the congressional process. I participated in two Defense Science Board task forces in the early 1990s, one of depot maintenance, one on privatization. We expressed many of the same ideas that Mr. Weston has expressed. For the most part, they have gone nowhere, and the reason why is because each one of these activities represents large concentrations of votes, in some cases enough votes so that you could argue it would affect the outcome of congressional elections.

You need only ask yourself the question, if Eglin Air Force Base were not in Florida, who would be in the White House today, to see the significance, the electoral significance of some of these issues.

Chairman CONRAD. Could I stop you right there and ask you—I don't want to miss the point. Depot maintenance, you referenced that and you apparently—what is your estimate of the surplus capacity in depots around the country?

Mr. THOMPSON. That is a very complex calculation. The Department of Defense spends more money on equipment maintenance than the entire NASA budget, the entire space program, about $15 billion a year. The most intensive amount of that work, the one that is done for the most part by civilian Federal workers, is done in a handful of very large logistics facilities such as Warner Robbins Air Logistics and Portsmouth Naval Ship Base.

You could close several of those facilities. More importantly, you could substantially downsize and outsource the work at those facilities, probably saving at least $1 billion a year if you adopted best practices. But it is not going to happen. It is not going to happen because the congressional resistance would be so fierce that in the end you would wish you had never tried.

Chairman CONRAD. Okay. Dr. O'Hanlon, what is your observation on this tooth-to-tail question?

Mr. O'HANLON. It is a tough question, Senator, because, of course, most of our tail is very important to the military. And if you look at our military compared to many other militaries, we have a lot more tail, and we are also a lot better. And if you compare it to the Vietnam era, we are lot better today than we were when the tail was only 50/50. I am not saying the tail is the reason, but I am saying that a lot of what we do in the way of deployable logistics that allows us to put hundreds of thousands of forces into a foreign country and operate there effectively, that can be defined as tail, but it really is inherent to combat capability.

So in the end, even though I agree with my colleagues, I am not that comfortable talking about 30/70 and 70/30 ratios. I like to focus on the big areas of military O&M spending, like Loren just did in the case of maintenance, and say where can we save money. And it seems to me the big areas are health, which is one enormous area, base operations—you know, take base operations. Maybe I will just spend a second there and then stop. Base operations, it is amazing to me, you have a person who is running a base who is also, let's say, a one-star general, and he is a combat expert, but he is also expected to run a base and be the chief financial officer for essentially a small town and for all of its physical plan. I think sometimes we make unrealistic demands on these people, and I am not sure if the services are properly set up to, you know, have the same person—I am not sure it is realistic to have the same person running the wing or running the division and trying to figure out how to make that base efficient. And so to give that person incentives, you need to tell that person some of this savings that you might get from any reforms, you are going to get back for your combat activity. Then that person has an incentive to hire people to work for him who know how to make the right choices about housing, about base repair and so forth.

So I am concerned not so much about the 30/70 ratio, but about certain specific areas, like health care, base maintenance, O&M, where I think we already spend a great deal of money, and some of these things are really not contributing in a great way to combat capability. But much of the logistics tail is important: intelligence, logistics, transportation. These are things that we do uniquely and uniquely well among the world's military. So I don't want to lose that part of the 70 percent even as we reform the parts that should be reformed.

Chairman CONRAD. Let me just say that I don't think anybody who has seriously looked at the financial management systems of DOD has concluded anything other than they are way, way, far away from business best practices. I don't know how you would manage the Pentagon. And I can tell you, the Secretary is very frustrated. As a man who came out of the corporate world where he insisted on management information that would allow him to save money, eliminate duplication and waste, anybody who has looked at the financial management data that flows through the Department of Defense, it is a huge problem. I think probably anyone would acknowledge that.

Mr. Weston?

Mr. WESTON. Mr. Chairman, if I could piggyback on your last comment with, I think, a useful anecdote, during the Tail to Tooth Commission's research, we were invited by the United Kingdom's military to visit their logistics group. They had started out with a very deficient finance and accounting system, and I realize as I mention the U.K. that no two countries are the same, but I want to share a story with you.

They concluded it was terrible. They brought in two outside consultants. This is not a paid ad. McKenzie was one of them, and Coopers & Librand was the other. And they came up with the specs for what is an appropriate financial control system. They got the specs. They outsourced it. And for $800 million, in their lesser environment, they got a turnkey installation of a system that us private sector guys, when we saw it over there, said was darn good, much better than ours.

The message I give you is that if, as I think is necessary, this committee and your colleagues in the Senate recognize if you don't have a reporting system, you can't hold anybody accountable for anything. You don't even know what is going on. And, therefore, I think it is time to get away from business as usual, budgeting as usual, and insist that the Secretary of Defense, together with knowledgeable colleagues, come up with a plan that will give you a financial control system for the future. Otherwise, for the next 20 years, one year at a time, you will continue to have an inadequate system. And if it takes a few billion dollars up front, that is probably the best investment this Nation can make.

Chairman CONRAD. Senator Stabenow.

Senator STABENOW. Well, thank you, Mr. Chairman, and thank you to all the witnesses. Your information is extremely helpful. I think we have a special responsibility and duty this year to make tough decisions, to ask tough questions. We heard yesterday regarding the future obligations and unfunded liabilities that we are incurring in the next couple of decades as it relates to our budget. And we have some very tough decisions to make. So we appreciate the information.

I was interested in, Dr. O'Hanlon, your suggestion about essentially putting the current costs for the war into a supplemental. I think there is some merit to that, Mr. Chairman. That would make sense to me. And I was also interested in light of that, when you said in your conclusion that most of the proposed increases have limited relevance to the war on terrorism in the current budget. It seems to me it would help us be able to debate the issue if we were looking at what was needed currently for safety and security and the war and then the long-term implications of the rest of the request.

Mr. Weston, I wondered if you might expand a little more. It is very disturbing, even knowing that obviously we need those who are not directly in combat to support those who are. That makes perfect sense, whether it is intelligence, whether it is other individuals that are involved in the logistical end of the strategies and combat and so on. But I think it is safe to say that the average American would be very disturbed to know that seven out of ten people or seven out of ten dollars does not go directly into the fighting force to keep us safe and secure. And I think about our schools, and what if we were to say that only three out of seven—or three out of ten of the staff were actually working with the children, or in the health care area only three out of ten were actually treating patients? So I think this is an area of concern to me, and I wondered if you might give us an example to illustrate and speak a little bit more about the tail that you would believe is, in fact, not directly related, as Dr. O'Hanlon said, to the support of our combat readiness, our combat troops, but what you would view as excess tail.

Mr. WESTON. Let me give you several examples in no order of priority. Generally, the military builds and maintains its own housing, knows very little about building housing, knows an equally small amount about maintaining housing; and if you spoke to the people who occupy that housing, you would hear huge dissatisfaction. Our point of view at the Tail-to-Tooth Commission was that if ever there were an area where this Nation has extremely skilled entrepreneurs, it is in building and maintaining housing. We do that all over the country.

I will not amplify further, but that is just one example.

Senator STABENOW. Excuse me, Mr. Weston. So you are suggesting essentially a privatization of that function, or—

Mr. WESTON. Absolutely. Outsource the building, the maintenance, the operations, everything about housing. A house is a house is a house. In fact, if you were in the private sector, you would never make a row of tenements called military housing; you would want to make it feel like a community. Any private sector developer knows that. You take a look at military housing—it is just a bunch of rowhouses.

It is not anybody's fault, but the military does not have that talent. It does not add to our fighting effectiveness. It is absolute "tail," poorly run.

Let us take something else. There are many functions that are business functions in the military that I previously called "yellow pages," meaning that you can go into the classified section of a phone book and find somebody—find a lot of somebodies—who does "x". What I am going to say now is not a commercial. ADP is not interested in doing any payrolls for the military. However, the military with its three payrolls—it has made some progress lately—viewed them as being so unusual that only they could do them in the Defense Finance and Accounting Service. Outsourcing those payrolls—and I am not looking for them at ADP; I would reject them if they came our way, just so that I would not pick up a stigma—it is another example.

There is another aspect. We heard words about logistics, replenishment, acquisition. In the private sector, as every one of our very skilled service secretaries knows from their private experience, before you get to procurement, you are at a pre-acquisition phase, and you look for full life-cycle support if you can arrange it, instead of having your own depots and your own parts as a military. I would think that the whole area of buying and maintaining logistics and repair support on complex hardware could benefit a lot if you used the commercial practice, worked with the potential vendors pre-acquisition, set specs that require full life-cycle maintenance, do not have those depots, do not have stacks of obsolete inventory all over the place—and you would not have the 18-day average replenishment cycle the military has to get a replacement part. The private sector would not stand still for 18 days; they get it in 3. That whole thing has to be reviewed. There are probably 100,000 people involved in the acquisition phase at the Pentagon. They are all sincere, well-meaning people. But I am positive that Secretary Rumsfeld knows how to do that procurement better. I think he needs the encouragement and the priority to get on with it. And then, the Secretaries have to stay in office longer than the current average of 19 months. There is no major job, including Jack Welsh's—in his first 19 months at GE, he did not produce the results; he was setting the stage.

I have been told that at the Pentagon, the average term in office of the senior civilians looking backward has been 19 months. Now, you cannot mandate a change, but that is a part of the circumstance.

Senator STABENOW. Thank you.

Would either of our two other guests wish to comment in relation to those items, or do you have differences of approach?

Dr. Thompson?

Mr. THOMPSON. I would like to comment briefly.

Since Mr. Perry was Secretary of Defense, we have been moving increasingly toward the privatization of housing. If you look at the presentation of the defense budget on OMB's website for 2003, you will see a fairly extensive amount of housing privatization already underway.

As far as the depots are concerned, I think we have to recognize that managing the Pentagon is as much of a political process as a management challenge. One of your colleagues on the Senate side said to me a little over a year ago, just before the Senate changed hands, when I remarked to him that Mr. Rumsfeld would actually like to close a major depot in his State, said to me: “Well, you tell them that if they do, they have lost their majority in the Senate.”

I think that explains why we have been recognizing and calculating the savings from these kinds of changes for decades and yet we have done very little, because the political system is stacked against making these sorts of changes, and it is not going to respond to the management arguments.

Senator STABENOW. I very much appreciate what you are saying. I would just comment that in light of the overall budget situation that we face and the stark numbers that we continue to hear, we have to revisit those issues over and over again. We are not going to be able to just indicate that it has not been done in the past, so we are not going to be able to question it in the future, because we have a lot of issues that we are having to revisit. And I appreciate that it is very much in our court, some of those tough decisions and policies. But when we look at all of the numbers—and I am not speaking of defense now, but in general—they do not add up, as our Chairman has said many, many times, and we are going to have to find the best way to make sure that we are safe and secure, but using our dollars wisely, and ideally, being able to move dollars within the Department, or every department, to get more bang for the buck, and I guess in defense, that is a literal as well as figurative statement.

I have one other question to ask—Dr. O'Hanlon, did you want to respond to that?

Mr. O'HANLON. I was going to make a very brief point. Loren is right, of course, that we need to try to make some of these reforms. But I also think the Administration owes it to Congress in a sense to make some tough choices itself, because from my perspective, the Administration is saying, “You make all the tough choices, you close the bases, close the depots; we are going to keep all the weapons systems that the services want.” And this is a pattern that has existed now for a while. I think that Secretaries of Defense need to be willing to make some people unhappy at the Pentagon just as they are asking you to make some of your constituents unhappy in closing bases. And frankly, I do not see that atmosphere of shared sacrifice from the Administration, and I did not see it that much even from previous Secretaries of Defense who kept these, in my opinion, exorbitant weapons modernization plans and expected Congress to make all the reforms.

So I would say we do need more procurement spending, but it has to be more carefully targeted, and some programs need to be cut back.

Mr. THOMPSON. I would like to take issue with that.

Senator STABENOW. Yes.

Mr. THOMPSON. It is true that there are very few major weapons systems that have been terminated. On the other hand, if you look at what we are actually buying, the Administration is requesting five ships in its shipbuilding plan this year. The Clinton administration was planning to buy eight. If you look at where this takes us, it takes us to less than a 250-ship fleet by the mid part of this decade, when in fact we had 600 ships—not much more than a decade ago.

If you look at the purchase of aircraft for the Navy, it is less than half the number the Navy says it needs in order simply to maintain its existing force. And if you look at the Air Force, if we buy every single fighter that is in the program of record, the average age of Air Force fighters between now and 2020 will go from 14 to 18 years.

So maybe there are some programs that should have been terminated, but the notion that we are overspending on procurement in general is belied by the age of the systems.

Mr. O'HANLON. I did not say that we were overspending. I said that the plans are too ambitious. And these aging problems could get worse if you try to buy $100 million fighters and you do not have enough money to buy them.

Senator STABENOW. I appreciate that.

If I might just in conclusion, Mr. Chairman, ask a broader question. We are looking at ways to guarantee, and we are putting more dollars into the "tooth," as you would say, Mr. Weston, to be able to make sure that we are focusing specifically on safety and security of our people, that we are doing the maximum amount possible, which we all want to do. And when we look at the very large requests for additional dollars coming in—and again, Dr. O'Hanlon, you have indicated that most of those have limited relevance to the war on terrorism—how would you suggest we proceed?

My concern is that by granting large increases, most of which do not relate to the war on terrorism—and frankly, we have other bioterrorism needs where we are not putting the dollars in that our experts are telling us we need to in order to be protected on bioterrorism—but where do we put the pressure on? If we provide the dollars as opposed to saying we must look internally to move more of the 70 over to the 30 so that the internal pressures is on to be able to make the difficult decisions rather than just adding dollars upon dollars and not creating a climate where the tough internal decisions need to be made, that is a real concern and question that I have as to whether we are in the long run doing a service to the long-term goals if in fact we do not put some internal pressures on to grapple with these efficiency issues as quickly as possible rather than just adding more dollars and adding more dollars.

Yes, Mr. Weston?

Mr. WESTON. I think what has happened in the past is that if there was pressure emanating from Congress, it was only exercised on the Pentagon as regards essentially the total dollars. And if you look backward, if the total dollars were not adequate to buy enough "teeth," we did not buy enough "teeth," and we left the overhead in place.

If all this committee does is recommend a different total from what has been submitted to you, it would be my guess, as has been the case in the past, that we will create cavities in the "teeth" because that overhead, even though some housing has been outsourced, will continue.

I think it would be a contribution to this Nation's security if this committee and your colleagues in the Senate and hopefully ultimately in the House come up with an enforceable message on addressing the “tail”; otherwise, you will just address the total, the “teeth” will suffer.

Post-Reagan, as things were brought down, there was far more bring-down in fighting forces than there was in the overhead, and it will happen again if you only address the total and you do not address some kind of mandate for tackling this overhead.

I think it is interesting that none of the panelists—and, for that matter, none of the Senators—have disagreed with the fact that we are full of excessive overhead, and if that is a continuing circumstance for the last 20 years, which it has been, there is a message in that observation.

Mr. O'HANLON. I would just add one point, Senator. I certainly agree, but I would also refer to a very good study just written by Bob Hale, my former boss at CBO who was Comptroller of the Air Force for a number of years. He wrote this report from the CSBA think tank, and it is easily available. He said, basically, it is very hard to get savings in O and M. You have to keep trying, but you should not have unrealistic expectations.

So I think the Senate Budget Committee needs to say more than let us reform the “tail” because if you do that, people like Hale who have looked at this and tried to do it are going to say, yes, that is right, but you are going to get $500 million in savings here, $200 million in savings there, and if you want to get to these grandiose multi-billion-dollar numbers, it is going to take you many years to get there. So you have to focus on the other issues as well, and we have to have this debate about procurement and figure out a plan that is sustainable and that does prevent our forces from getting too old but may impose some tough choices on the services, and have the debate about military pay. It is easy for me to say; in 2003, an elected Member of Congress would perhaps have a harder time debating that issue. But unless that issue gets raised, because we are putting so many benefits into the personnel package and into the personnel accounts that that account is going up, just as Loren mentioned earlier. All of our accounts are going up, including the “tooth,” and some of those increases in “tooth” are needed, others may not be.

So I think you have to look at all four major accounts—pay, O and M, R and D, and procurement—and if you do not look at all four of those, you are not going to get enough money out of just the overhead alone.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Before I go to Senator Corzine, just a quick note. We got some good news. The economic growth in the fourth quarter of 2001 was 1.4 percent at an annual rate, so better than was anticipated, and that is certainly useful news to this committee.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. I appreciate you holding the hearing.

This is really the first opportunity that I have had to explore the budgetary elements of the defense procurement and management issues in this kind of detail, and I think that we are onto an obligation that is absolutely essential if we want to be able to have a legitimate budgetary process that has accountability to it and the kinds of things that we have been talking about here.

I also want to compliment Josh Weston, who is a New Jersey native and has done an extraordinary job of running an efficient company for a very long time, both profitably but also with the efficacy that I think he is talking about here with respect to trying to bring those principles to bear on the Pentagon, and I welcome my good friend.

I want to ask Dr. Thompson whether you agree that there might truly be 670 poorly-connected major data systems in the Pentagon.

Mr. THOMPSON. Well, speaking as somebody who has been thinking about buying ADP stock for years, I am inclined to defer to the other person on the panel about information systems.

If I could offer you a response by analogy, I participated in the Privatization Task Force back in the mid-1990's in the Department—

Chairman CONRAD. Dr. Thompson, could you pull the microphone in front of you, please?

Mr. THOMPSON. [continuing.] Sorry. We proposed that a number of these things—data processing, financial accounting, and so on—should be outsourced to get the kind of efficiencies that are characteristic of ADP. Maybe the Arthur Andersen option is not as attractive today as it used to be. But at the time, the Department told us they wanted to fix it before they outsourced it, and as a consequence, most of these activities are still in the Department.

The point that Josh makes about an average political appointee having a tenure of 19 months tells you a lot about why there does not seem to be much continuity. There are always neat ideas in terms of management reform floating around the building, but they last about as long as those appointees do in the positions.

So I find it quite possible that there are hundreds of, if not totally disconnected, poorly interconnected, data systems in the building and in the system.

Senator CORZINE. If that data point is real, one could understand how you would end up with enormous duplication, lack of accountability with regard to what the mission is and what is accomplished, and as I said, I am new to this process, but if that is the case, you are going to get bad results no matter what happens if you do not have the kind of integrated approach of understanding the financial information.

I am not challenging you, but if we have the single largest part of our budget going in this area, and we do not have the ability to actually track it and manage it, we are going to get gross over-expenditures relative to where we should be. I find it incredibly difficult to understand this kind of management structure with regard to such an incredible amount of expenditure we have, particularly when we have the tough choices about whether we are going to fund the procurement that seemingly needs to be in place.

Mr. Weston?

Mr. WESTON. Since I know and lots of other people know that in your prior life, you were at Goldman Sachs, one of your predecessors as CEO at Goldman Sachs specifically helped the transition group at the Pentagon on the financial reporting system. I think members of this committee or perhaps yourself or your staff might want to ask Steve Friedman, who chaired that group, to share with you what their findings were, which they did deliver to Donald Rumsfeld.

It is absolutely apparent that the financial reporting system is utterly broken, and if anybody spends a lot of time trying to decide if it is broken, you are rehashing something that is a foregone conclusion.

I think the real issue is what do you do about it. And if every year, you say this budget is only a one-year budget, and you cannot fix it in a year, so let us not tackle it, then for 20 years in a row, you will not fix it.

Senator CORZINE. I think we have an identified target of opportunity here, at least with regard to the needs for reform that I hope would lead to resources being made available for the other things that I think everybody finds necessary.

I would like to pursue a little bit the propositions of Dr. O'Hanlon, talking about substituting procurement of equipment that may not be the 21st century's latest model as a substitute for some of the things—procurement of the F–22s or other high-cost elements. Is this a viable military strategy?

Mr. THOMPSON. I think the hardest thing about budgeting for defense is that there is a lot of subjectivity in terms of predicting the future. Some people would say that the notion that we need to put more of our money into the war on terrorism is an optical illusion; that in fact the reason why we are fighting this asymmetric threat is because we have done such a good job of defending ourselves against the really big threats, that now, nobody will even challenge us on that score, and therefore, our principal obligation should be to make certain that we remain so overpoweringly effective against a future peer or regional adversary that only a nut like Osama bin Laden would seriously try to challenge us.

If that is what has actually happened here, it would be folly to put a lot of effort into counterterrorism, because that is the residual category. It is the least challenging threat. It is the big threats that could really harm us in the future, and that is where we are beginning to lose ground.

Let me just tell you a little anecdote in that regard. A friend of mine, Major General David Deptula, used to be the head, the commander, of Operation Northern Watch, the Iraqi no-fly zone. About 2 years ago, he was flying his F–15 over northern Iraq, and all of a sudden, everything in his cockpit stopped working at the same time. He did not know what had happened. He managed to limp back to base, and when they tore down the aircraft, they discovered that the F–15 that he was flying was so old that the insulation had turned to powder, and his cockpit was shorting out. On closer examination, it turned out he was flying the same F–15 that, as a young pilot, he had flown at Kadina Air Force Base in Japan a quarter-century earlier.

Now, this is not one of those random events. On that particular mission when his cockpit went out, he was receiving refueling from a KC–135, which is 40 years old; it is an old Boeing 707. He was getting jamming support from an EA-6B Prowler, which traces its origins to the Korean War.

This is not a revolution in military affairs; this is a revolution in museum affairs. This force is falling apart. And I do not think the way to maintain our edge in the world is to buy more F–15s. They were designed in the 1960's. We need new planes.

Senator CORZINE. Well, there is a need, though, to measure that or weigh that or balance that against the absolute resource constraints that we have, and if there are other opportunities for us to look at different mixes as opposed to just saying that we need to go from zero to 100, one wonders whether that is an effective strategy. I guess that is what I am hearing from Dr.—

Mr. THOMPSON. I think you may be right, Senator, but I would just like to make one other point about that. After spending a year looking at these issues, the Rumsfeld team really could not come up with much that was new, that the Clinton administration was not already planning to do.

There is in effect a bipartisan consensus within the Department as to what needed to be done. That is why they did not change the plan very much. I do not think it is driven by bureaucracy; I think it is driven by a recognition of what the operators need.

Senator CORZINE. The one issue that I have—and maybe you talked about it before I got here—is on the missile shield. Is that "tooth" or "tail"?

Mr. THOMPSON. Are you talking to me?

Senator CORZINE. Yes.

Mr. THOMPSON. I guess it is "tooth" if we ever deploy it. I myself grew up in New Jersey very close to one of the first missile defense sites, or at least that is what it was supposed to be, and since that time—

Chairman CONRAD. Dr. Thompson, could I just ask you again to pull the mike a little closer? These mikes are very sensitive, and if they are not right in front of you, we do not pick you up as well, and I want to hear what you are saying.

Mr. THOMPSON. I understand. Since I grew up in New Jersey near that first-generation missile defense site, we have been through Sentinel, we have been through Safeguard, we have been through SDI, and I do not know what the new thing is called, but the one thing they all have in common is that we never ended up with a missile defense system. So I guess until they actually build something that works, they will have to call it "tail."

Mr. O'HANLON. Senator, if I could just continue the conversation on procurement very briefly, if you do not mind, Loren quoted earlier this Marine Corps officer who is concerned about his 35-year-old helicopters, but the Marine Corps is contributing to the problem, in my judgment, because they are saying the solution is to build the V-22. Well, the V-22 is not ready yet, so more delay. Once it is ready, it is going to cost twice as much per copy as a modern helicopter we could be buying instead; so if budgets are constrained, yet more delay.

To my mind, the Marine Corps talks as if the only solution to the aging equipment problem is the V-22 for troop transport. In fact, the V-22 may exacerbate the problem because of the delays in the technology development, because of the high cost per system.

So again, I think that a mix of capabilities there would give you some of the long-range, high-speed strike you need for commando raids or special-purpose missions, but allow you to refit your force more quickly with lesser technology, but still very good and reliable technology—because Loren is right—you cannot fly around things that are 20 and 30 and 40 years old and do that indefinitely. The question is not whether you get rid of them, it is what do you replace them with. I think that that distinction needs to be highlighted.

Also, if you look at how we have done in Operation Enduring Freedom or Operation Allied Force or what have you, we often flew the same kind of airplane and put better things on it. So the JDAM munition—we did not even have the JDAM in Desert Storm, and it turned out to be the star of Operation Enduring Freedom even if it was being dropped by B–52s that are a half-century old, because the munition is so good and the targeting from some of these unmanned aerial vehicles is so good that we are improving even as the weapon platforms stay the same.

So I think you want to have a force that is reliable, that is young enough that it is safe, and you want to push technology, at least for this silver bullet force in case you do face a China or someone else in the future, but you do not need to replenish the entire force structure with the most expensive modern platforms available.

Chairman CONRAD. Could I just intercede on this question, and I know Senator Stabenow wanted to follow up, too, and we can be more informal at this point with the number of Senators here.

I think just the age of the aircraft can be misleading, and let me give you an example. The B-52s that you just mentioned, Dr. O'Hanlon, it is often said that they are much older, maybe twice as old, as the pilots who fly them, and it is true. A number of years ago, I asked General Loh, who was head of Air Combat Command and a very good friend, "Mike, how long are these planes good for?" He said, "Kent, these planes are good until 2035. With all the modernization, all the upgrades that have been done and with their low flight times"—he said when you compare the flight times on these frames against the flight times on commercial aircraft, these planes are good until 2035.

The Air Force has now updated that analysis. They say the planes are good until 2040. Does that mean you are not making any improvement in their war-fighting capability? Absolutely not, as we have seen with ERCMs, with what is being done with respect to JDAMs. They were the stars in Afghanistan. Read the quotes of the Taliban leadership; the thing that devastated their morale was when the B-52s came over and dropped a big stick on them and scared the hell out of them, killed a lot of them.

So I think we have got to be careful. I am certainly willing to accept the argument with respect to F–15s that have a lot of tough hours on them; our tanker fleet, average age 40 years—no question. We have got to be putting money into procurement there. The helicopter situation—there is no question in my mind that we have got to be putting money into newer helicopters. In my State, we have 10 helicopters now, and generally, one can fly. That makes no sense. We have a helicopter fleet that cannot go anywhere.

But I do think it is very important to keep in mind this question of just the pure age does not necessarily reveal a need for something else.

Senator Corzine.

Mr. THOMPSON. Could I respond to that?

Chairman CONRAD. Yes, absolutely.

Mr. THOMPSON. Senator, it seems to me there are two parts to the aging issue. There is the actual decrepitude of some of these systems, the corrosion, the metal fatigue, and so on. But in addition to that, there is the relative age of the technology on the aircraft compared with what adversaries might have.

The B-52 is a good example. The B-52 was conceived in Dayton, Ohio in 1948 as a high-altitude penetrating bomber. The threat got worse, so then it became a low-altitude penetrator. By the mid-1970's, even the North Vietnamese were able to shoot them down in large numbers. Today, nobody in his right mind would actually penetrate a well-defended country in a B-52. The reason we used them over in Afghanistan is because they were defenseless; they had no defenses. But it is still a very old technology no matter what shape the air frame itself is in.

Chairman CONRAD. Yes, but they are also incredibly effective, and every time we have a conflict, the first thing we fly off to do something is a B–52; and now they have a stand-off capability that is really quite remarkable that they did not have. Nobody in 1948 had any clue that you would be able to use a B–52 as a stand-off platform and fire cruise missiles, and now extended-range cruise missiles that give you a capability that is really quite remarkable.

Senator Corzine.

Senator CORZINE. I was just going to follow up. Anecdotally, I visited the 177th in Atlantic City last week, which is the fighter wing that is flying caps over Washington and New York City. They had two F–16s go down, one for certain mechanical breakdowns, and they are targeted to be replaced, but with F–22s or joint strike fighters 15 years out.

We somehow have to get between now and there with the kinds of capabilities that we have, and unless we have some derivative of the suggestions that Mr. O'Hanlon is talking about, I do not know how we can get there. It just does not seem logical that we are going to be able to replace all these things immediately, and if we are going to be budgeting to start building these as a full replacement, we are going to end up having this aging problem that we have been talking about here on a whole series of things in the intermediate stage. It just does not ring that it is going to work—

Mr. THOMPSON. I think that assessment is accurate. We are living now with the consequences of the Clinton administration's procurement holiday. All of a sudden, we have a force that is aging across the board, and we are not sure what we are going to do between now and when we replace it, assuming we stay on track for the modernization plans, which in the past we have not done.

The problem with continuing to fly F–16s is that it is either going to be very expensive because older aircraft are harder to maintain and keep ready—hence, this rapidly upward-spiraling operations and maintenance account—or you are going to buy new F–16s, and new F–16s, according to the Air Force, are not survivable. They are not stealthy. They do not have a number of the features that will be incorporated into the F–22 or into the joint strike fighter. It is not that they are not great aircraft. They are great aircraft today. But the Air Force is trying to think out 20 to 25 years in terms of what the threat is, and they do not believe they can survive much less maintain air superiority in F–16s.

Mr. O'HANLON. Although I have had individual Air Force officers agree with me that an F–16 Block 60, which is the latest version and still quite economical, is a very good airplane. It has some improvements in its stealth, and it is very effective especially with these longer-range munitions. You might not want to fight China's elite air force in 2020 with that part. That is why you do want some modern aircraft—but you do not have to have all 2,000 of the Air Force's fighters be stealthy planes, I do not think.

Senator CORZINE. It seems that we are trying to do all things at once, and it is a questionable theory in all walks of life that I have ever been involved with, at least in the private sector.

I appreciate it, Mr. Chairman.

Chairman CONRAD. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

To follow up on Senator Corzine's comment about doing all things at once, I wanted to go back for a moment to the national missile defense, when we look at tough decisions that have to be made, and in light of September 11, we came together to allocate $40 billion to deal with what happened on September 11 as well as the need to move forward on the war on terrorism; and then, I look at a number of $60 billion that has been suggested for national missile defense that we have yet to be able to operationalize, and Dr. Thompson, you said at the moment that since we have not been able to get it to work, you would put it in "tail" as opposed to "tooth." We have to make some tough decisions that relate to this question—a) what is the biggest threat; are we going to need, as we have been discussing here in the last few moments, more conventional aircraft and conventional forces; are we going to be called upon, as I believe we are, to address terrorism and the more conventional interchanges that we will be involved in around the world, and is it in fact realistic that a rogue country will choose to deploy a missile when we will be able to identify exactly where they are and respond with incredible force back to them, or is it more likely that they will attempt to do what they did on September 11. I think common sense and the majority of the public in really looking at this would say they are much more concerned about bioterrorism or threats of terrorist activities right now.

So I am wondering—Dr. O'Hanlon, you have written a book, "Defending America: The Case for Limited National Missile Defense," and you talk about that there should be a slow and deliberate process of coming to some kind of national missile defense—I am wondering how long do you think we should be putting dollars in, what should be the amount of dollars into research, before we say this is it—we have other areas where we need to be putting dollars that are right now a much, much bigger threat to Americans. Where do we draw the line on this?

Mr. O'HANLON. Thank you, Senator.

I am personally not in any rush to deploy, but I do not want to slow things down too much, either. To my mind, the big question is why do you need eight or nine separate missile defense programs, all of them robustly funded, and why do you have to envision a very, very large missile defense, which is essentially what the Administration is doing.

So instead of the $8 billion a year budget, we are now being asked to fund, I would be more comfortable at the $5 to $6 billion a year level that the Clinton administration left with, and that includes money for theater missile defense as well as for longer-range or national missile defense. I think that level of spending—mostly R and D, of course, right now, except for some limited theater missile defense procurements—that level of spending to me is about right. The Bush administration is putting $8 billion into missile defense, and it wants to go up to $11 billion by 2007; if it then deploys the kind of systems that it might, CBO's recent study suggests that the total acquisition cost of that could be over $200 billion. Now, CBO acknowledges there is no way to be sure what the Administration will really ultimately propose—there are no specific deployment plans just yet—but we could be looking at budgets that go from $8 billion today to $11 billion in 2007 to $15 billion a year if you go for an ambitious missile defense, and maybe even more. I think the level of threat is sufficient to justify a serious program, but I would put it at $5 or $6 billion a year today, ramping up to possibly $7 or $8 billion once we start to deploy.

Senator STABENOW. I guess my question is before we deploy, we have to have a system that can be operationalized, and even in theater missile defense, we have seen the Navy cancelling contracts, saying we do not believe we are able to move forward in a responsible way, getting things to work and so on.

At what point—how long do we go on R and D before we say that maybe there is someplace else we should invest our resources that has a better chance of truly making us safe?

Mr. O'HANLON. It is a tough question, but I would tend to say we should keep trying. Of course, as Loren well knows, there are different levels of missile defense, and some of them are working pretty well. The Patriot PAC-3, which is also now this hit-to-kill capability, has done reasonably well the last few years on the test range, but it is just for local defense against short-range missiles. I think that program is in pretty good shape. I think Congress should fund the procurement request of the Administration for at least most of those systems.

Then, you have the theater missile defense system center that you mentioned, the somewhat more advanced ones, going up to even these Navy theater-wide and THAD capabilities. That is the next tier of difficulty, and then you have national missile defense, which is the hardest of all because the threat is moving in so fast and is so small.

There are three different capabilities. The first one, we are getting close to be able to do, and I think our deployed forces do need that kind of protection. The second tier, the Navy areawide, and then the Navy theater-wide or THAD, that is harder, it is going to take us a few more years, but I would keep at it.

The national missile defense, I also would like a limited system, because I agree with your point—it is not the most plausible threat, but there are scenarios that I could imagine where someone might consider launching a few missiles at us in a very worst case. Let us say we are marching on Baghdad to overthrow Saddam

Hussein. Well, thank God he does not have long-range missiles. But let us say the scenario is 10 or 20 years from now, and it is not Saddam, but it is one of his sons, and that he does have a long-range ICBM, and we are saying we want to overthrow him, and he says, "Okay, at this point, there is no reason for me to hold back."

So there are scenarios that I could imagine where a limited defense would make sense, but it is not the most plausible scenario, and we do not need a huge capability for that threat.

Senator STABENOW. I would just comment that I hope we have dealt with Saddam Hussein long before that situation occurs.

Yes, Mr. Weston?

Mr. WESTON. For a very long time, accountants and others have used this R and D term. It may be useful to you for me to add this comment. "R" you know stands for research, "D" stands for development. Normally, you do a lot of research before you satisfy yourself in development, and you are not talking about one subject, you are talking about two, and this committee or some other committee might want to examine how you divide your management and resource allocations between an "R" and a "D"—and if you lump them together and say that is R and D, we will give you "x" dollars or two "x", you might not be dividing the "R" from the "D" appropriately.

But having said all that, I think the last 10 minutes have been dealing with very important questions. No matter how you choose to answer them, I am positive you will run up against constraints in money that you wish you did not have to deal with. And the only way to deal with that one—I am sort of becoming a broken record now—is concurrently tackle the "tail" thing, because if you do not tackle the "tail" thing, no matter how you resolve the questions you have been asking, you will not be able to fund as many "teeth" as you think is appropriate.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Let me go back to this question, because it really is centrally important. I have had top uniformed military officers at very high levels tell me privately that they are very worried about the amount of money we are spending on national missile defense. And let me say that I have long been an advocate of national missile defense. Dr. O'Hanlon, I am pretty much on your wavelength on national missile defense. I do think it makes sense to invest money first in those shorter-range systems but also to continue a robust effort on national missile defense. But I must say the President's proposal leaves me cold, because CBO tells us that for limited-layer defense, we are talking about $150 billion.

Where is the money coming from? We are already in deep deficit. We are already under the President's plan going to be taking $2.2 trillion out of the Social Security and Medicare trust funds over the next decade, right at the time the baby boomers start to retire.

We had testimony here from the Comptroller General of the United States just yesterday that we have nearly $7 trillion of unfunded liabilities. This is getting more and more like Enron. Enron got in trouble because they hid their debt. They hid it from investors, they hid it from shareholders, and I think in some ways they hid it from themselves. I think these guys—I think some of them knew what was going on, but I will bet you a lot of them really did not appreciate the debt bomb they were facing as a company, and it led to catastrophic failure.

I will tell you that as a country, we are not facing up to the debt that we are building. Chairman Greenspan came and met with me, and he said, “I am very concerned about these so-called contingent liabilities, because they are not contingent at all. The vast majority of them are real liabilities, and we are not facing up to them.”

I guess my frustration, the more I know, the more I learn in this position, the more frustrated I become that we are just in a dream world here in terms of our long-term fiscal condition as a country. So it makes these decisions all the more critical.

I do not see $150 billion for national missile defense over the next decade, and yet I believe strongly that we have got to pursue national missile defense. But I think we have got to do it at a level that is more affordable.

Let me go to another point and really my final question, and that is on the fighter aircraft. I should complete the thought with respect to what the top uniformed military officials have told me. These are non-Air Force, by the way. They have said to me, “We are deathly afraid that this thing is going to eat the rest of the procurement budget for things that are really needed to defend this Nation in the future.”

Now, these are private conversations. Obviously, they are concerned about being on the team and yet having grave reservations. Do any of you share that concern?

Mr. THOMPSON. Do you mean the overall size of the three aircraft programs together?

Chairman CONRAD. Well, first of all on the question of national missile defense, what the Administration is doing there in terms of a long-term commitment; and then on the three fighter aircraft, I was going to follow up on that. We are doing the F–22; we are doing the FA-18E and F; and Joint Strike Fighter. Before September 11, there was a lot of talk that we have got to consolidate, that we cannot do all three. So I guess I have a two-tier question. On national missile defense, do any of you share the concern that top military officials—and I mean very high-level uniformed military leaders—have talked to me about, that it is going to eat the long-term budget of their services?

Mr. THOMPSON. I can certainly confirm that they are saying that. We may be talking to the same 4-stars, but I have heard them say exactly the same thing.

My own personal prejudice—I think you and Michael are correct, that the right way to go is with a limited deliberative system rather than with any kind of more ambitious system.

The threat is uncertain, but it is sufficiently serious that we need some sort of defense against an accident or a rogue attack, but beyond that, a very comprehensive crash program—I do not know—we have done it several times before, and it does not seem to go anywhere. I am kind of inclined to think that there is a message there.

Chairman CONRAD. Let me just say that Safeguard was operational for one day. I was up there the day it was operational.

Mr. THOMPSON. Well, operational is not the same as effective; right?

On the subject of the fighter aircraft, the basic problem that we face is that all the fighter aircraft are getting old simultaneously, and unlike the tankers or the bombers, these things do maneuvers that wear them out very quickly.

There is a difference of opinion in each one of the three services that are receiving the Joint Strike Fighter as to precisely what role it is going to play and precisely how important it is. But in each one of the services, you find that at least one of those three systems is considered to be absolutely critical. As far as the Marines are concerned, the Joint Strike Fighter is absolutely critical to their future. That is the way the Navy feels about the SuperHornet, and that is the way the Air Force feels about the F–22. The case the Air Force makes on the F–22, since it seems to have the most controversy around it, is "Look, we asked for 740; then Bush cut it to 648; then Clinton cut it to 438, then to 339; and now another Bush has cut it to 295. We still believe that without this aircraft, we cannot maintain future air superiority against a truly capable adversary. So now is the time to stop cutting since we have already spend over a third of the cost of the program anyway."

Chairman CONRAD. Can you just go through those numbers again, quickly? We started at 750.

Mr. THOMPSON. At 750; and then the Bush administration, if I recall correctly, in the major aircraft review, cut to 648; and then the Clinton administration cut to 438, subsequently to 339; and then most recently, last year, the Bush administration cut to 295.

Chairman CONRAD. Just looking in this budget, the procurement for the F–22 has gone up from 13 to 23; the F–18 SuperHornets have actually been reduced from 48 to 44; and of course, Joint Strike Fighter is still in R and D.

I agree with you—the Marines have told me exactly what they have told you, that they see the Joint Strike Fighter as absolutely essential to their operations.

So what I hear you saying is we ought to go forward with all three.

Mr. THOMPSON. Yes.

Chairman CONRAD. Dr. O'Hanlon?

Mr. O'HANLON. I do not think I would cancel any one, Senator, but I would severely curtail the size of the F–22 and the JSF in particular. For example, on the JSF, I might go from a total buy of close to 3,000 among the three services to closer to 1,000 and then buy things like F–16 Block 60 for the rest of the force structure.

Chairman CONRAD. What is wrong with that idea, Dr. Thompson?

Mr. THOMPSON. Well, the F–16 was designed to be a low-cost fighter a quarter-century ago. Today, it may be a low-probability victory fighter.

Just to take one simple example, if you look at the tail of an F–16, the vertical stabilizer and horizontal stabilizer are at right angles to each other. That is a guaranteed strong radar return on any radar. People do not build fighter aircraft like that anymore because you get shot down.

We had aircraft like B-1s that even the Serbs were shooting the trailing decoys off of in Operation Allied Force. We were scared to put things like F–16s over Serbia. Serbia is a country that spends as much on defense in a year as NATO does in a day, so what happens if we face a real enemy?

Chairman CONRAD. Okay. That is a very good point.

Are there any further questions, Senator Corzine?

Senator CORZINE. No.

Chairman CONRAD. Can I just again thank this panel. You have really been a terrific panel, all three of you, excellent witnesses and very helpful to the committee. We very much appreciate the time and energy that went into preparing the testimony and the very thoughtful contributions you have made here today. We appreciate it—and best of luck to your wife, Dr. O'Hanlon.

Mr. O'HANLON. I appreciate it, Mr. Chairman.

Chairman CONRAD. The committee is adjourned.

[Whereupon, at 11:55 a.m., the committee was adjourned.]

THE CONGRESSIONAL BUDGET OFFICE'S ANALYSIS OF THE PRESIDENT'S PROPOSALS FOR FISCAL YEAR 2003

WEDNESDAY, MARCH 6, 2002

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, Feingold, Stabenow, Corzine, Domenici, Frist, and Hagel.

Staff present: Mary Ann Naylor, staff director; and Jim Horney, deputy staff director.

For the minority: G. William Hoagland, staff director; and Cheri Reidy, senior analyst.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

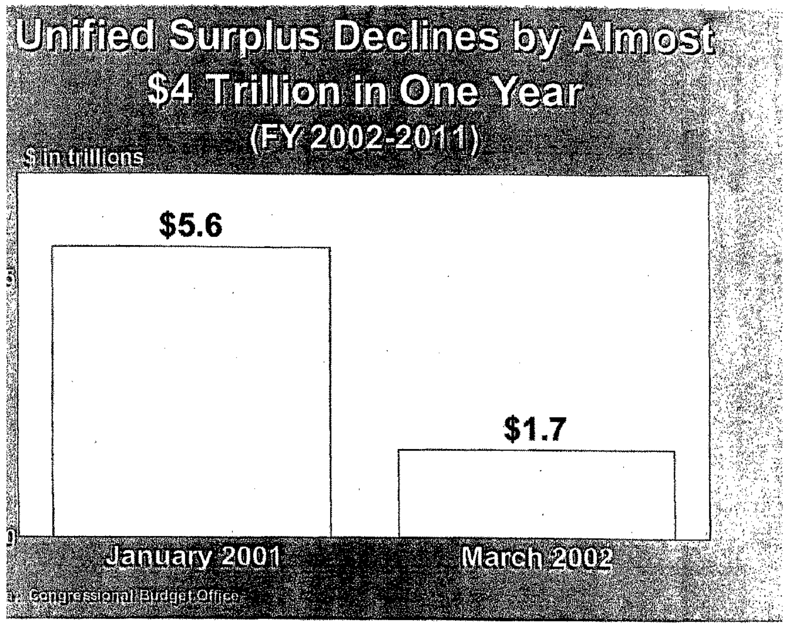
Welcome, Dr. Crippen.

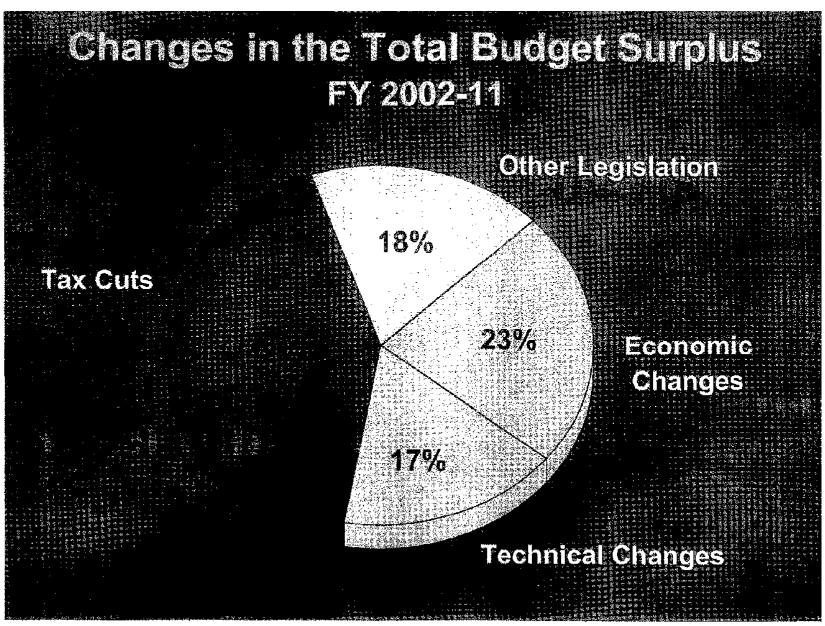
Mr. CRIPPEN. Good morning.

Chairman CONRAD. It is good to have you here. We appreciate your coming to tell us about your revised baseline and CBO's estimates of the effects of the proposals in the President's budget for fiscal year 2003 and beyond.

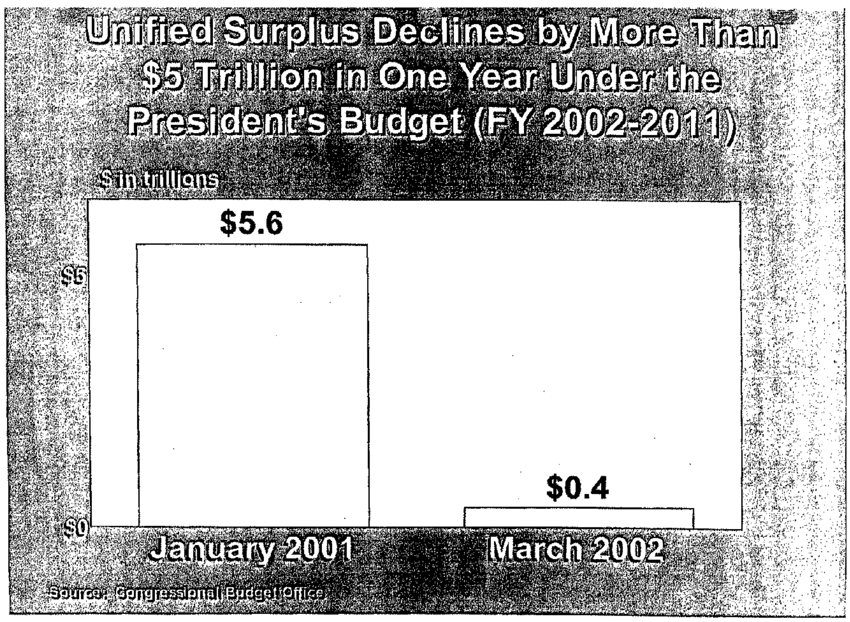
I first want to commend you and your staff for the very hard work that you have done to produce this analysis in such a short time. We are deeply appreciative of the fact that you have worked overtime and your staff has worked overtime to produce this analysis in order to move ahead with the budget resolution on the compressed schedule that we face this year. We have a somewhat different circumstance because of when the work breaks for Congress fall and the effect of that on the budget process. It has put enormous pressure on all of us to step up the schedule, and you have responded and we appreciate it very much.

Just 6 weeks ago, you testified how much had changed in the last year. You told us that we had gone from projected surpluses of $5.6 trillion over the next decade to $1.6 trillion. The news is a little bit better today, but not much. Instead of a $4 trillion disappearance of projected surpluses, it is $3.9 trillion, still a very dramatic change. And when we look at where the money has gone, we see that most of it has gone to the tax cut over the 10 years. The next biggest reason is the economic slowdown. The next biggest reason is the additional spending that has come about largely as a result of the attack on this country. And, of course, then there are some technical changes, what had been previously underestimates of costs of programs such as Medicare and Medicaid.

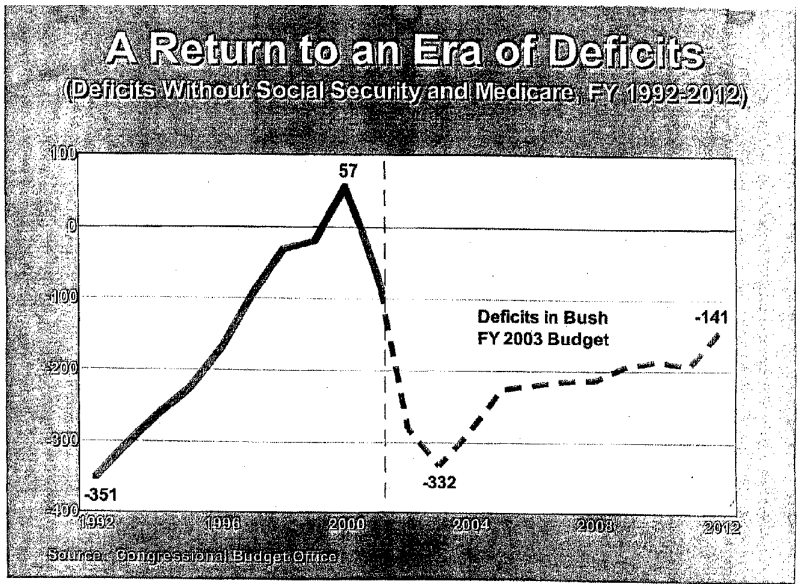




Now we have got the President's budget as well, and when the President's budget came out, he showed that about $5 trillion was gone. Actually, things are somewhat worse under your analysis than what he had told us. We have gone from $5.6 trillion over the 10-year period to $400 billion. And I must say that I think the use in Washington of the word "surplus" misleads the American people because I think they conclude from that there is extra money here, that there is more money than we need, and that is not the case. The truth is all of these dollars have been fully committed. In fact, I would argue they are overcommitted. There truly are no surpluses.

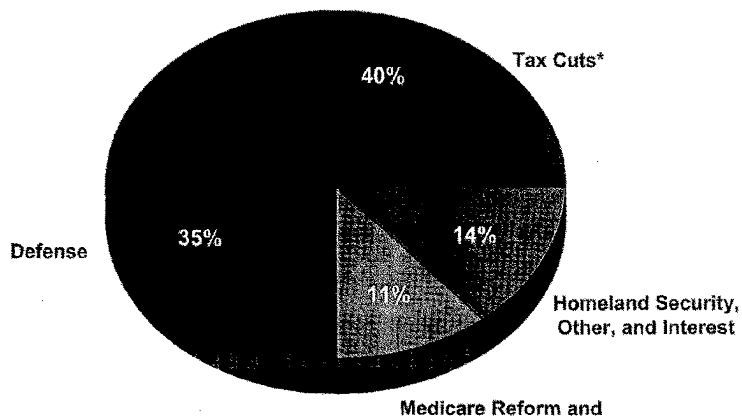


Let me go to the next chart. What we see over the next decade, when you take out the trust funds of Medicare and Social Security, we see continuing red ink. If the money from Social Security and Medicare, those surpluses, are not counted, the so-called non-trust funds accounts, we see deficits each and every year for the next decade.


A Return to an Era of Deficits
(Deficits Without Social Security and Medicare, FY 1992-2012)
100
0
-100
-200
-300
-400
57
-351
-332
-141
Deficits in Bush
FY 2003 Budget
1992
1996
2000
2004
2008
2012
Source: Congressional Budget Office

Let's go to the next chart. With the President's budget, we see that of his priorities, those amounts over the so-called baseline, the biggest priority is additional tax cuts; second is national defense, which is a priority we all share; the next biggest is homeland security, of course, which we all know has to be strengthened; and, finally, Medicare reform and prescription drugs. So those are the priorities the President has set going forward.

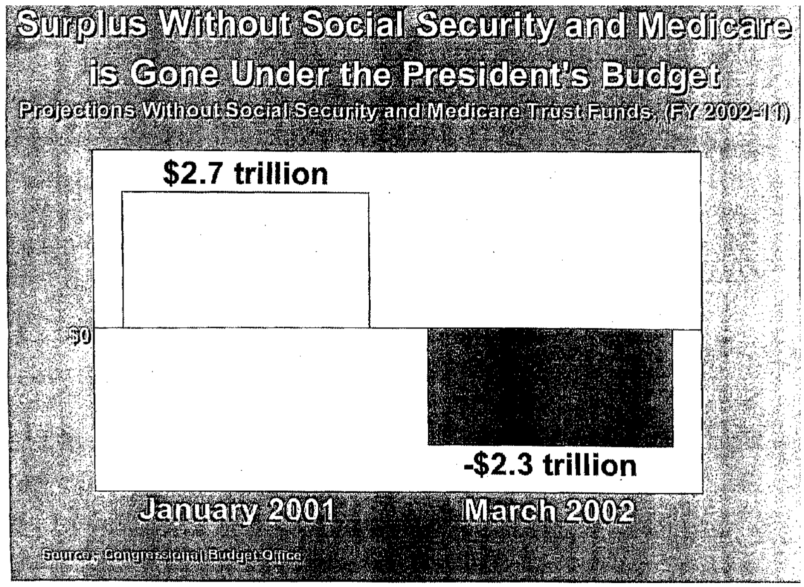
The President's Spending and Tax Priorities (Amounts Spent Over Baseline, FY 2003-12)



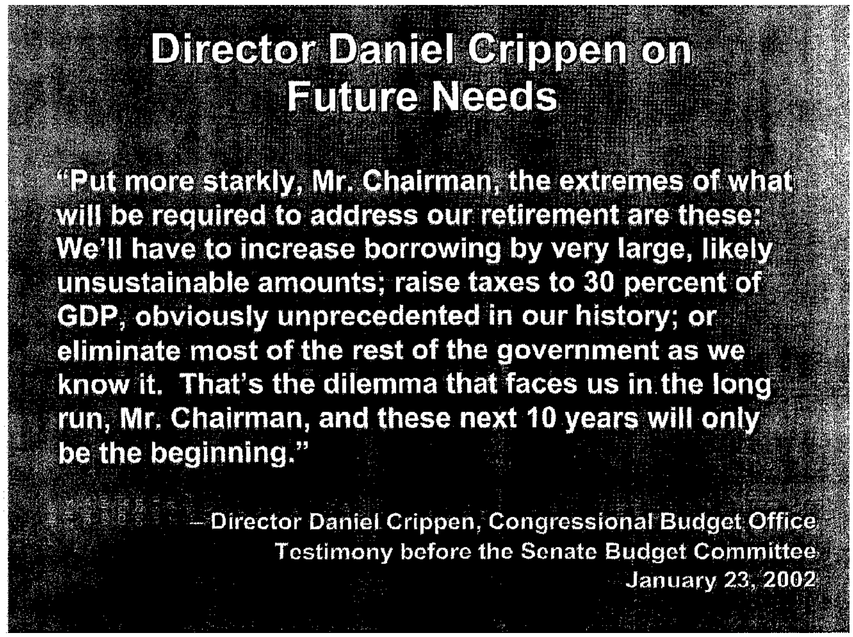
*Note: Tax Cuts include nonrefundable tax credits.

The very serious problem that we see with respect to the trust funds is we are going back to the bad old days when we were taking all of the trust fund surpluses of Social Security and using it to pay for other purposes. We largely stopped that in 1998. We completely stopped it in 1999 and 2000, started slipping backward in 2001, but now we are back on path for the next 3 years to be taking every dime and using those funds to pay for other expenses of Government, including the tax cuts.

Let's go to the next chart. The other very notable change as we look forward is last year we were told we could expect outside of the trust funds some $2.7 trillion of surpluses, and now we see instead $2.3 trillion of deficits over the 10-year period. And, of course, all of that is coming from the Social Security and Medicare Trust Funds.



Let me just conclude with a statement that you made when you were before the committee previously. When you were before us, you said, "Put more starkly, Mr. Chairman, the extremes of what will be required to address our retirement are these: we will have to increase borrowing by very large, likely unsustainable amounts, raise taxes to 30 percent of GDP, obviously unprecedented in our history, or eliminate most of the rest of Government as we know it. That is the dilemma that faces us in the long run, Mr. Chairman, and these next 10 years will only be the beginning."



I think you sounded a warning that has been repeated before this committee by the Comptroller General of the United States that is critically important for this committee to hear, for our colleagues in both Houses of Congress to hear, and for the administration to hear, and certainly for the American people to hear, because we are headed on a long-term course that is simply unsustainable.

As the Comptroller General indicated, the numbers do not add up. This has got to discipline what we do on both the tax-cutting side and the spending side.

Let me re-emphasize that. I hope the message that is delivered is very clear. We have got to discipline ourselves on the spending side and on the tax-cutting side if we are to begin to cope with these long-term challenges. That to me is the simple reality. And it has got to inform our actions here and in the larger Congress and in the administration as well.

Let me just conclude by saying there is a little bit of good news in your remarks: that on a unified basis—that is, when the trust funds are included—you see before the President's budget, before his policy changes, you see slight unified surpluses in 2002 and 2003, which is somewhat of a change from before. But, again, that is before the President's budget proposal.

When you then put in the policies the President is proposing, we are right back to substantial deficits, according to your analysis, some $90 billion of deficit in 2002, some $121 billion of deficit on a unified basis in 2003. Obviously, those are concerns to all of us, and with that I will turn to my very able colleague, Senator Domenici, the Senator from New Mexico, for his comments, and then we will go to your testimony.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

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

I have a prepared statement that I would like to be made part of the record, and I just have a few observations.

Chairman CONRAD. Without objection.

Senator DOMENICI. Thank you very much.

First, Mr. Crippen, I want to commend you and your staff for the work they have done in helping us and helping the American people better understand our budget and have a more objective picture of what the fiscal and tax policy of our country is.

Specifically, I want to say thank you to you and them for the extra hours that must have been spent to get the work out as promptly and as early as you have, and obviously we couldn't have proceeded unless you did that. So thank you very much.

First, I believe what I see in fiscal policy for the next 10, 12, 15 years is very positive, not negative. I see a fiscal policy, depending upon how we proceed beyond the President's budget, I see 10 years when things are very good. As a matter of fact, I would like to comment on the Social Security Trust Fund and the unified budget because I believe you served up here when Ronald Reagan was President; you helped Howard Baker during the early days of the budget resolution. And, clearly, we were on cloud nine when we could talk about a balanced budget. The balanced budget was a unified balanced budget. Clearly, that was a goal that was deemed to be great fiscal policy, and we hardly ever achieved it.

I asked this morning about the history of the Social Security program versus the budget, and I think I am correct that since Social Security was initiated, we have only had an on-budget surplus eight times. Now, I don't know how many years Social Security has been—how long has it been since it started? Since 1965.

Now, the reason I make the point is because everybody got their checks; seniors did not have to come up here and lobby for us to give them their checks. So there was no surplus of the type we are talking about that we in the last 2 or 3 years have come up with, that is the off-budget surplus that includes Social Security and Medicare.

So while we have a problem to overcome, one of education, one of understanding, one of building confidence with the American people, it would appear to this Senator that you bring us rather good news with reference to the next few years and good news over the long run because of what I have just indicated. And I would say that there are three pages that are very important in your CBO testimony, three tables. Table No. 1, everybody should know that the on-budget surplus for the current services baseline, meaning before the President's requests are added, CBO's baseline shows us in surplus under the unified budget all the way across, including this year. That is a change from your previous testimony, upward, which is very helpful. It moved from what to what for the year 2003? It is now $6 billion, a small amount. What was it in your previous estimate?

Mr. CRIPPEN. I think it was—$14 billion, Senator.

Senator DOMENICI. All right. And the other one that I think everybody should take a look at is the last table, the second page of

Table No. 11. The reason I think that is an important one, Mr. Chairman, I think it is very important to you as you attempt to mark up this budget, because this shows what happens if we don't have the President's stimulus in the package. And that is very interesting. If you don't, you will be in balance as far as the President's programs without the stimulus. If that is the goal, to be in balance, because we can't get enough votes to vote for one that is not in balance either here on the floor, I will vote for one that is not in balance if it has the other things that are right.

Then the third one that I think is very important for everyone is the first page of Table No. 11. That is the CBO's estimate of the President's budgetary proposals. So this says where we will be if we adopt the President's plan. And clearly we go from balance to non-balance, but it would seem to this Senator that with a war, just coming out of a recession, so long as we have reason to think we will come out of the recession soon—and I think we will. We might already be out of it. And so long as we are not going to be in a war for a number of years but, rather, a realistic number of months and maybe no more than a couple years, clearly spending what must be spent leaves the United States with rather good fiscal policy nonetheless, and that is compared to what we have had in previous history.

So I am very optimistic as far as the fiscal policy. We will not get these $200 and $300 billion surpluses, off-budget surpluses for quite some time, but that doesn't mean Social Security will be in trouble. It hasn't been in trouble the last 35 years, and we did not have those kinds of surpluses. In fact, we didn't seek them. We talked about tax cuts as soon as we had an on-budget surplus that we could look at in order to revitalize with tax cuts. So thank you for that, and thank you very much, Mr. Chairman.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Welcome Director Crippen back before the committee this morning.

Mr. Chairman, this will probably be the last Senate Budget Committee hearing before we proceed with out responisibilities to craft a budget resolution for the coming year, and Mr. Chairman, I think I have a good sense as to just how difficult this will be, having been in your shoes a few times over the history of this committee, but that job is not made any easier on all of us—by what seems to me to be an unusually high level of uncertainty today.

There is uncertainty about the economy both in the near term and over the longer horizon. Is the recession over? Was there ever a recession? For some maybe it never was, but for others looking for work today—it has never ended. Or maybe the recovery will be weak—or maybe events in the world will cause recent growth to falter.

We are at war against terrorism not just in Afganistan but increasing around the world. We continue to experience weakness and uncertainties in the largest world economies—in Japan and in Germany.

No words can adequately describe the torment, uncertainty and stress that permeates the Middle East today, and the mood in Latin America is down right depressing.

Then, what must seem so trivial in light of these more global concerns, here in this committee we have the complicating uncertainties created by an expiring Budget Enforcement Act at the end of this year and what that might mean for the future of the budget process and this committee.

Is it any wonder then Dr. Crippen, that the business you are in of making projections about the future course of the economy is loaded with challenges, trap doors, adn distraught Congressional clients.

I know that some members in the other chamber have recently questioned your position—ignore them—it comes with the turf, but before I hear once again how far-off your projections or the “Republicans' projections” were from a year ago, I need to remind everyone that unless they somehow are blessed with perfect foresight—nobody knows today if they were right or wrong. Who knows? The economy may surprise all of us, as it did in the 1990's, and your projections of a year ago have an equally likely chance of still being right.

None of us will know until we actually get to 2010 and look back, even then we may not know. This is risky business a CBO Director or for that matter being the Chairman of a Budget Committee, but even with all the risks and uncertainties involved, I still beleive it is necessary and essential that the process goes forth. Some anchor, some basis is needed to compare and contrast the policy decisions we make here for the American public, and that starts for this committee's work this year with your testimony this morning.

I look forward to you pre-policy estimates and your analysis of the President's budget Dr. Crippen.

Chairman CONRAD. Thank you. I would just say one thing. In my reading of the CBO report on the question of the budget excluding the economic stimulus for 2003, we still would have deficits, some $43 billion, as I read it, for 2003. So even without the stimulus package, according to CBO, with the President's spending and tax proposals, we would still have a deficit in 2003.

Senator DOMENICI. You are right.

Chairman CONRAD. That gives us a challenge here obviously.

Senator DOMENICI. Next year.

Chairman CONRAD. Yes.

Senator DOMENICI. And thereafter, we are in balance with a surplus, which I think is pretty good news.

He is correct. I change my remarks as to what year it is. We are not in balance the year we are writing a budget for under the President's, but the next year we are in balance.

Chairman CONRAD. And, you know, this committee has a very serious challenge. Let me say one other things about this whole question of Social Security. I don't think the past is a good indicator for the future because we face this demographic time bomb called the baby-boom generation. And what was done before doesn't work going forward. It is why I counsel the committee and counsel our colleagues, we have got to restrain spending and tax cuts if we are to prepare for what is to come.

It is a very sobering change. You know, in 1950, there were 16 workers for every retiree. Today, there are 3.3 workers for every retiree. We are headed in a circumstance in which there will only be two workers for every retiree. That is a dramatic and fundamental change, and it means we have got to change. It means we have got to do things differently.

With that, Director Crippen, again, I want to thank you and your staff for an extraordinary effort to get these estimates to us in a way that is timely for the work of the committee.

STATEMENT OF DAN L. CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. CRIPPEN. Mr. Chairman, Senator Domenici, thank you for your accolades. As usual, the credit goes to those of my colleagues who are sitting behind me and those who were left behind. They are the ones who put in the extraordinary hours and were able to produce the analysis before you today. I only represent them on most occasions, as I do today, but thank you very much for your accolades. They have worked very hard to get this to you in a timely way.

Mr. Chairman, Senator Domenici, members of the committee, I am pleased to be here today to discuss the President's budget for 2003. As it does each year, CBO, with assistance from the Joint Committee on Taxation, has estimated the effects of the President's budgetary proposals using our own economic and technical estimating assumptions.

In conjunction with this analysis of the President's budget, we have updated the baseline projections that we published in January. That update incorporates new technical assumptions and a slight revision of our economic forecast as well. CBO currently projects, as you said, Mr. Chairman, that the Federal Government will run a small surplus, $5 billion, this year and a surplus of $6 billion next year. Those surpluses would total $490 billion over the first 5-year period and roughly $2.4 trillion over the 10-year period. That 10-year total is $117 billion higher than the figure we published in January, as your chart showed earlier.

The first chart I would like to show today, Mr. Chairman, is roughly what the two paths would look like under OMB's numbers and ours. We estimate that under the administration's proposals, the budget would record a deficit of $121 billion in 2003 and $51 billion in 2004 but revert to surpluses thereafter. Over the first 5-year period, the budget would run a cumulative deficit of $33 billion, and over 10 years, it would show a cumulative surplus of $681 billion.

On the spending side of the budget, the President proposes to raise discretionary outlays by just under $300 billion above our baseline, comprising an increase of $480 billion for defense, offset by a reduction of $190 billion in non-defense discretionary spending.

Outlays for mandatory programs would exceed our baseline levels by another $440 billion over the 10-year period, mainly because of proposals to restructure and expand Medicare, to assist people who lack health insurance, to change the funding mechanism for military retirees under age 65, and to increase spending on agriculture, food, and nutrition programs.

On the revenue side of the budget, the President proposes to reduce receipts by $600 billion over the 10-year period, according to estimates by the Joint Committee on Taxation and CBO. More than 60 percent of those reductions would occur in the last 2 years of the period, largely as a result of extending the tax cuts enacted last year, which are scheduled to expire, as you know, in 2010.

The President's budget would lower revenues in 2003 by $73 billion; $65 billion of that reduction comes from the stimulus package, an unspecified proposal to stimulate the economy through tax cuts and additional spending.

Overall, the administration proposes to spend about $2.1 trillion next year, 19.5 percent of GDP. Total spending would rise to $3.1 trillion, or by an additional $1 trillion, by 2012. But since the economy is expected to grow, the share of Federal spending would drop to 17.8 percent. Revenues, on the other hand, would continue to grow relative to the economy: from 18.4 percent in 2003 to 19.1 percent in 2012.

With two exceptions, CBO and OMB have remarkably similar outlooks and estimates in our baselines. Those two exceptions are revenues, particularly in the early years, most notably in 2003, and Medicare spending over the decade. You will see graphs in the testimony that show you both of those items in a little more detail, the differences in revenue baselines and Medicare baselines between CBO and OMB.

First, OMB and the Treasury believe taxes on corporate profits will be slightly higher in 2003 and 2004 than we do—$21 billion and $13 billion higher, respectively, for those 2 years, or roughly 10 percent of corporate revenue in those 2 years, but only 1 percent of total revenue.

Second, CBO projects higher Medicare spending over the decade, largely because we expect more cases, more recipients of home health care and skilled nursing facilities, and more expensive patients. Our difference with the actuaries is small, amounting to 7 percent of total Medicare spending over the decade, and is mostly due to differing assumptions on how well the new payment systems for these services will work in holding down future costs.

Mr. Chairman, in light of the economic data released over the past 3 months, CBO has modified slightly its economic forecast for calendar year 2003, with faster growth of real and nominal GDP and higher corporate profits.

As we have all seen and been encouraged by, the economy seems to be rebounding in what could only be called a remarkable fashion. When CBO and the administration prepared their forecasts in December, most economists thought that the economy was headed downward in the fourth quarter of 2001. However, the economy has done much better than any of us forecast. It grew at an annual rate of 1.4 percent in the fourth quarter. In fact, for the first two quarters of this fiscal year, we expected combined growth of negative 0.5 percent. Instead, it looks like growth will be more than 1 percent over the last quarter and this.

The surprises in the recent data are further encouraging because they involve both consumer and business spending. Consumption has remained extremely strong, as we also reported in January, contradicting expectations about the effects of the weakness of the stock market, job losses, and consumer concerns after September 11th.

The evidence for a rebound in business spending in the first quarter of 2002 is more tentative, but it points in the same direction. Orders and shipments of capital goods suggest an upturn in this sector. News stories about commercial construction have been less positive, but after sharp declines since March 2001, the January data show an encouraging increase. The largest contribution of the business sector and the most uncertain, as always, is inventory accumulation. Inventories dropped by $120 billion in 1996 dollars in the fourth quarter. The rate at which they will be rebuilt remains unclear, but even the end of the inventory decline would add several percentage points to GDP growth.

The outlook for growth in coming months, however, is still uncertain, as it usually is around turning points in the business cycle. Several factors may be adding to the current uncertainty. First, the fact that this winter has been unusually warm is probably distorting a number of economic indicators.

Second, forecasters who expect relatively strong growth most likely anticipate a relatively rapid return to inventory building. But that is among the hardest elements of the economy to predict.

Third, other sectors that usually contribute to growth during cyclical recoveries, especially autos and housing, are unlikely to play the same role this time. It remains unclear to what extent the auto sales of the past few months have simply borrowed from future sales, and investment in housing has remained strong throughout the recession and probably cannot contribute much more to growth than it is already doing.

Finally, Mr. Chairman, I want to highlight the changes in the long run that have occurred, as you indicated in your chart, between January 2001 and today. The question my chart attempts to address is: Can we regain those rosy surpluses or large surpluses simply through the change of the economy we have seen in the last few weeks? And the answer, certainly, is not entirely. What has happened, of course, as we reported in January, is that since last December the BEA has reduced its estimates of business fixed investment in the national product accounts, for several recent years. In addition, plus the current, albeit mild, recession has reduced the base of the economy upon which we can grow. This chart shows you nominal GDP, hich drives nominal Federal revenues, and in this case we don't believe we can recover entirely what was lost in the base, due to both data revisions and the recession.

So all that is to say, Mr. Chairman, that this quick turnaround and shallow recession will not put us back here next January again talking about a 10-year surplus equivalent to $5.6 trillion. The turnaround is certainly encouraging, and the more the economy grows, the better off we will all be, in the long run. But it won't produce the same kind of revenue stream that we had hoped it would earlier.

With that, Mr. Chairman, I am open for questions.

[The prepared statement of Dr. Crippen follows:]

The Prepared Statement of Dr. Dan Crippen

Mr. Chairman, Senator Domenici, and Members of the Committee, I am pleased to be here today to discuss the President's budget for 2003. As it does each year, the Congressional Budget Office (CBO), with assistance from the Joint Committee on Taxation (JCT), has estimated the effects of the President's budgetary proposals using its own economic and technical estimating assumptions. Several main points emerge from that analysis.

- CBO estimates that under the Administration's proposals, the budget would record a deficit of $121 billion in 2003 and $51 billion in 2004 but revert to annual surpluses thereafter. Over the five-year period from 2003 through 2007, the budget would run a cumulative deficit of $33 billion; over the 10-year period from 2003 through 2012, it would record a cumulative surplus of $681 billion (see Table 1 on page 17). The on-budget accounts, which exclude the spending and revenues of Social Security and the Postal Service, would remain in deficit throughout the 10-year period.[1]
- In conjunction with its analysis of the President's budget, CBO has updated the baseline projections that it published in January. (Those projections estimate the future path of spending and revenues if current laws and policies do not change.)

[1] 1. These estimates are preliminary because JCT has not completed its analysis of the Administration's tax proposals. Numbers in the text and tables may not add up to totals because of rounding.

The update incorporates new technical assumptions and a slight revision of CBO's economic forecast. CBO currently projects that under the assumptions of the baseline, the Federal Government would run a surplus of $5 billion this year and $6 billion next year. Surpluses would total $489 billion over the 2003-2007 period and $2.4 trillion over the 2003–2012 period. That 10-year total is $0.1 trillion higher than the figure CBO published in January.[2]

- Relative to that updated baseline, the President's budget would reduce projected surpluses in each year through 2012, CBO estimates. Over 10 years, those reductions would total $1.7 trillion; excluding debt service, 55 percent of the reduction would result from increases in spending and 45 percent from decreases in revenues.
- On the spending side of the budget, the President proposes to raise discretionary outlays by $295 billion above baseline levels between 2003 and 2012—comprising an increase of $483 billion in defense spending offset by a reduction of $188 billion in nondefense spending. Outlays for mandatory programs would exceed baseline levels by another $436 billion over the 10-year period, CBO estimates, mainly because of proposals to restructure and expand Medicare; assist people who lack health insurance; change the funding mechanism for the health benefits of military retirees under age 65; and increase spending on agriculture, food, and nutrition programs. (Those figures exclude the Administration's proposal that Federal agencies pay the full cost of benefits for their employees as such benefits accrue.)
- On the revenue side of the budget, the President proposes to reduce receipts by $602 billion between 2003 and 2012, according to estimates by JCT and CBO. More than 60 percent of those reductions, or $379 billion, would occur in the last two years of the period, largely as a result of extending the tax cuts enacted last year that are scheduled to expire at the end of 2010. The President's budget would lower revenues in 2003 by $73 billion; $65 billion of that reduction comes from the Economic Security Plan, an unspecified proposal to stimulate the economy through tax cuts and additional spending.
- Overall, the Administration proposes to spend about $2.1 trillion—or 19.5 percent of the Nation's gross domestic product (GDP)—in 2003 (see Table 2). Total outlays would rise to an estimated $3.1 trillion by 2012, but because the economy is expected to grow faster than spending, Federal outlays as a share of GDP would drop to 17.8 percent. Revenues under the President's budget would increase from 18.4 percent of GDP in 2003 to 19.1 percent in 2012, despite the anticipated growth in the economy.

CBO'S ECONOMIC PROJECTIONS

In the light of economic data released over the past three months—particularly the Bureau of Economic Analysis's (BEA's) preliminary estimates for the fourth quarter of 2001—CBO has modified its economic outlook for calendar years 2002 and 2003. Compared with the forecast that it published in January, CBO's current forecast anticipates faster growth of real and nominal GDP during 2002 and larger corporate profits in 2001 through 2003 (see Table 3). Levels of GDP and other major economic variables in 2004 through 2012 remain unchanged. However, because the projected level of GDP in 2003 is slightly higher, growth rates of GDP in 2004 through 2012 are a little different than in the previous forecast.

Changes to CBO's Economic Forecast

The economy is currently rebounding in a remarkable fashion. When CBO and the Administration prepared their forecasts in December, most economists thought that the economy was headed downward in the fourth quarter of 2001, reflecting both the need to correct an excess of corporate investment in recent years and the trauma of the September 11 attacks. However, the economy has done much better than forecast. It grew at an annual rate of 1.4 percent in the fourth quarter, according to the BEA's recent estimates, and more than made up its losses from the brief downturn of the previous quarter. Moreover, although CBO (like many forecasters) anticipated a mild upturn in the first or second quarter of 2002, recent data suggest that the economy is surging ahead. Some forecasters are projecting that growth in the first quarter will be as high as 4 percent at an annual rate.

The surprises in recent data involve both consumer and business spending. Consumption has remained extremely strong throughout the past six months, contradicting expectations about the effects of weakness in the stock market, job losses, and consumers concerns about security after September 11. Some of the strength in the fourth quarter was attributable to sales incentives for cars, although other

[2] 2. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003–2012* (January 2002).

consumption remained strong. More surprising, consumption spending has been much higher than anticipated in the first two months of 2002.

Evidence of a rebound in business spending in the first quarter of 2002 is more tentative, but it points in the same direction. Orders and shipments of capital goods suggest some upturn in that sector. News stories about commercial construction have been less positive, but after sharp declines since March 2001, the January data for industrial, commercial, and other nonresidential construction showed an encouraging increase. The largest contribution of the business sector—and the most uncertain—is inventory accumulation. Inventories dropped by $120 billion (in 1996 dollars) in the fourth quarter; the rate at which they will be rebuilt remains very unclear, but even the end of the inventory decline could add several percentage points to GDP growth (at an annual rate) in the first quarter.

The economy's greater-than-anticipated output in recent months appears to reflect unexpected productivity growth, since recent measures of hours worked and employment are still broadly in line with the previous forecast. The income generated through that higher productivity seems likely to accrue to owners of capital. Consequently, CBO has raised its projections of corporate profits through the end of 2003. Although anecdotal evidence suggests that companies are reporting weak profits in their financial reports, such evidence is hard to interpret, and profit reports may be temporarily distorted by changes in accounting practices.

On the basis of recent data, CBO has raised its estimate of real growth in GDP to 1.7 percent for calendar year 2002. Its forecast of corporate profits is now 16 percent higher than in January. CBO's revised outlook is similar to that in the February *Blue Chip* survey of some 50 economic forecasters (see Table 4). Forecasts are changing rapidly, and it is likely that the March *Blue Chip* survey, which will be published in a few days, will reflect an even more robust view of the near term.

The outlook for growth in coming months, however, is extremely uncertain, as it usually is around turning points in the business cycle. Several factors may be adding to the current uncertainty. First, the fact that this winter has been unusually warm is probably distorting a number of economic indicators. Second, forecasters who expect relatively strong growth most likely anticipate a relatively rapid return to inventory building, but that is among the hardest elements of the economy to predict. Third, other sectors that usually contribute to growth during cyclical recoveries—especially autos and housing—are unlikely to play the same role this time. It remains unclear to what extent the auto sales of the past few months have simply borrowed from future sales. Moreover, investment in housing remained strong throughout the recession and probably cannot contribute much more to growth than it is already doing.

Comparison with the Administration's Assumptions

CBO's and the Administration's economic assumptions are fairly similar in their implications for budget projections. For 2002, the Administration's forecast of GDP growth is lower than CBO's, though the difference is made up in 2003 and subsequent years. Beyond 2002, the Administration assumes slightly lower inflation, as measured by the GDP price index, so its projection of nominal GDP remains below CBO's throughout the projection period (see Table 4). However, the Administration assumes that the major tax bases—wages and salaries, and corporate profits—will constitute a larger share of GDP than CBO does, and as a result, its projections of those tax bases are slightly above CBO's for much of the projection period. In addition to lower inflation, the Administration expects substantially lower interest rates and a lower unemployment rate than CBO does. All of those factors contribute to making the Administration's projections of outlays lower than CBO's over the 2003–2012 period.

CBO'S AND THE ADMINISTRATION'S BASELINE ESTIMATES

In general, both CBO's and the Administration's baselines are calculated according to statutory rules and guidelines in the 1985 Balanced Budget and Emergency Deficit Control Act and the 1974 Congressional Budget and Impoundment Control Act. The baseline serves as a policy-neutral benchmark that lawmakers can use to gauge the effects of new spending or revenue proposals, such as those in the President's 2003 budget.

Revisions to CBO's Baseline

In preparing its annual analysis of the President's budgetary proposals, CBO typically updates its baseline projections to take into account new information from the budget and other sources. CBO's current outlook for the budget is slightly more favorable than the one it published in January. In the absence of additional tax or spending legislation, the budget would show small surpluses in 2002 and 2003 ($5 billion and $6 billion, respectively) instead of the modest deficits projected previously (see Table 5). Under that assumption, the surplus would total $489 billion over five years, CBO estimates, and $2.4 trillion over 10 years, up from the previous projections of $437 billion and $2.3 trillion, respectively.

CBO has increased its baseline projections of revenues by $23 billion for 2002 and $15 billion for 2003 because of its upward reestimates for GDP and corporate profits in the near term (see Table 6). For years after 2003, increases to baseline revenue projections are relatively small, averaging just over a billion dollars per year. Most of the increases stem from receipts of the Universal Service Fund, which would be offset by added spending of similar amounts.

Among the few pieces of legislation enacted since the January baseline is Public Law 107-139, which amends the Higher Education Act of 1965 to establish fixed interest rates for student and parent borrowers and extends certain special allowances for lenders that would have expired for loans issued after June 2003. CBO estimates that the extension of the yield guarantee for private lenders and changes in interest rates charged for direct loans—as well as an increase in the volume of borrowers—will increase outlays by $9.5 billion over the 2003–2012 period.

Reductions in projected Medicare spending account for most of the changes to CBO's baseline since January. A variety of technical factors caused CBO to lower its projections of Medicare outlays over 10 years by nearly $80 billion:

- About $30 billion of the reduction stems from an analysis of newly published information on the rates to be paid to Medicare+Choice plans (health maintenance organization plans under Medicare) in 2003 and later years.
- About $35 billion of the decrease reflects the Administration's announcement of an effective date for a final rule concerning "pass-through" payments for hospital outpatient services and an analysis of new data on the cost of "buying down" (contributing more to) coinsurance paid by beneficiaries for hospital outpatient services.
- Another $15 billion of the reduction reflects an updated analysis of the effect on spending of the changing age distribution of the Medicare population, an improved method of constructing price indexes for projecting updates to Medicare's payment rates, and the effects of revised projections of outlays on premiums paid by beneficiaries.

Conversely, CBO increased its baseline projections of Medicaid spending for the 2003–2012 period by $21 billion. Much of that increase resulted from higher projections of enrollment and new waivers permitting Medicaid programs to offer prescription drug benefits to low-income Medicare beneficiaries. CBO also incorporated the savings generated by a recent regulation that limits the amount by which Medicaid's payments to hospitals may exceed payments based on Medicare's rules (the so-called upper payment limit).

Differences from the Administration's Current-Services Baseline

Both CBO and the Administration estimate that the budget will essentially be in balance this year under current laws and policies (see Table 7). CBO now projects a small surplus ($5 billion), and the Administration anticipates a small deficit ($9 billion). The difference between those figures mainly arises because CBO is forecasting lower short-term interest rates and projecting lower payments for Social Security benefits and the refundable portions of the earned income and child tax credits. Furthermore, CBO's estimate includes recoveries of overpayments in the Supplemental Security Income (SSI) program to reflect greater participation by SSI beneficiaries in Social Security's Disability Insurance (DI) program.[3]

been receiving DI benefits. Those individuals gained insured status for DI as a result of wages earned after becoming entitled to SSI benefits. Consequently, the Social Security Administration will pay those beneficiaries retroactive benefits under DI, but a large portion of the payments will be recaptured by the government as recoveries of overpayments in the SSI program. The President's budget does not include those recoveries, which CBO estimates would total about $2.4 billion in 2002 and $1.3 billion in 2003.

In both baselines, surpluses grow after this year, albeit at a slower pace in CBO's projections. For 2003, CBO's projects a baseline surplus of $6 billion—about the same level as it estimates for this year—whereas the Administration, anticipating higher revenues, projects a baseline surplus of $41 billion. For the next five years, CBO's cumulative baseline surplus ($489 billion) is $180 billion smaller than the Administration's ($669 billion). That gap widens for the 2003–2012 period: CBO's

[3] 3. The Social Security Administration has determined that roughly 200,000 disabled SSJ recipients should have

projected cumulative surplus (nearly $2.4 trillion) is $305 billion less than the Administration's (almost $2.7 trillion).

Revenue Differences. CBO's baseline projection of revenues over the next 10 years is nearly identical to that of the Administration—lower by only $15 billion, or less than 0.1 percent. In some years, however, the projections differ noticeably. For 2003, CBO's revenue projection is $35 billion lower than the Administration's, and for both 2004 and 2005, it is about $25 billion lower.

Different expectations for corporate income tax receipts account for the lion's share of those differences. CBO projects a lower average tax rate on corporate profits, especially in 2003 and 2004. The Administration assumes that certain factors pushed down corporate tax liabilities in tax year 2001 and that those factors will continue to affect receipts to some degree in 2002 because of lags in payments and the difference between the tax year and the fiscal year. However, the Administration does not expect those factors to persist in their effects on receipts beyond 2002. The assumption that those factors will be temporary pushes up the Administration's projected average tax rate on corporate profits beyond 2002. CBO does not feel it has sufficient information to identify any temporary factors (except those related to the economic forecast) that affect the projected average tax rate on profits.

For 2006 through 2010, CBO's and the Administration's projections of revenues are similar. After that, the picture changes. CBO projects larger receipts in 2011 and 2012 than the Administration does, partly because it makes different assumptions about what will happen when last June's tax cuts expire at the end of 2010 and partly because its projection of income is higher than the Administration's for those years.

Outlay Differences. On the spending side, CBO's baseline estimate of outlays over 10 years exceeds the Administration's by $291 billion, or about 1 percent. That difference reflects higher projections of mandatory outlays (by $138 billion), discretionary outlays (by $90 billion), and net interest costs (by $62 billion).

The main difference between CBO and the Administration in projecting mandatory outlays involves Medicare spending. For 2003 through 2007, CBO's baseline projections for Medicare exceed the Administration's by $55 billion (about 4 percent). Over the 2003–2012 period, that difference broadens to about $226 billion (7 percent).

CBO's higher Medicare estimates stem from its different economic projections and technical assumptions. About $40 billion of the 10-year difference is attributable to economic projections and arises because CBO projects that updates to Medicare payment rates, which reflect changes in prices, will be 0.1 or 0.2 percentage points higher than the Administration projects. Another $10 billion to $20 billion of the 10-year difference stems from possible administrative actions that the Administration's baseline assumes but that CBO's does not. The remaining difference, $175 billion over 10 years, reflects different technical assumptions about participation in Medicare+Choice plans and about spending for services provided in the fee-for-service sector.[4]

The biggest discrepancies between CBO's and the Administration's estimates of increases in spending in the fee-for-service sector involve skilled nursing services, hospital outpatient services, and home health services. The payment systems for all three types of services have been altered substantially in the past few years, and the extent to which the volume and mix of services will change under the new systems is uncertain. Both CBO and the Administration assume that increases in the volume and mix of those services will contribute less to growth in spending under current law than they did under the payment systems that existed before the Balanced Budget Act of 1997. In general, however, CBO assumes less of a reduction from those earlier rates of growth than the Administration does. For home health services, however, the Administration seems to assume more rapid increases in the volume and mix of services through 2005 or 2006 and a more rapid decline in the rate of growth of those factors in later years.

CBO's baseline projections for some other mandatory spending programs are lower than the Administration's. For example, Medicaid spending in CBO' s baseline is about $42 billion lower over the 2003–2012 period than the Administration estimates, mainly because CBO anticipates lower enrollment rates for the program. CBO's 10-year projections are also lower for Civil Service retirement benefits (by about $25 billion) and for the refundable portions of the earned income tax credit (by $41 billion) and the child care tax credit (by $21 billion).

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[4] 4. See statement of Dan L. Crippen, Director, Congressional Budget Office, *Projections of Medicare Spending Under Current Law*, before the House Committee on the Budget, February 28, 2002.

For discretionary outlays, CBO's baseline exceeds the Administration's for two principal reasons. First, the inflation rate that CBO uses to project discretionary budget authority in future years is slightly higher the Administration's. Second, the spending rates that CBO assumes for defense appropriation accounts are also generally higher than those used by the Administration. However, for fiscal years 2002 through 2004, CBO estimates that nondefense discretionary outlays will be slightly lower than the Administration expects because CBO anticipates that many nondefense agencies will spend balances of prior-year obligations more slowly than the Administration assumes.

CBO's estimates of net interest are lower than the Administration's for 2002 and 2003 and higher thereafter. CBO's lower estimates in the near term are largely driven by technical factors, such as differences in assumptions about the mix of securities issued by the Treasury. Starting in 2004, however, those technical factors are offset by economic factors, as CBO's projections of interest rates rise significantly above the Administration's, resulting in higher net interest estimates for the remainder of the projection period.

THE PRESIDENT'S BUDGETARY POLICIES

Overall, CBO's and the Administration's estimates of the President's budget are similar. Under both sets of estimates, deficits end after 2004 and give way to growing surpluses (see Table 8). However, within that broadly similar pattern, some differences exist. For most years after 2002, CBO estimates that deficits will be larger, and surpluses smaller, than the Administration does by $30 billion to $40 billion.

CBO estimates that deficits under the President's budget would peak in 2003 (at $121 billion) before beginning to fall. The Administration estimates that deficits would reach their high this year (at $106 billion) and begin declining in 2003. For the 2003–2007 period, CBO projects a total deficit of $33 billion under the President's budget; the Administration estimates a total surplus of $157 billion. For the 2003–2012 period, both CBO and the Administration estimate that the President's budgetary policies would produce cumulative surpluses—$681 billion in CBO's estimates and $1,002 billion in the Administration's. In both sets of estimates, the bulk of those surpluses accumulates in the later years of the projection period.

Policy Proposals Affecting Discretionary Spending

The President's budget would boost new discretionary budget authority for 2003 to $759 billion, CBO estimates, 6.9 percent more than the $710 billion enacted thus far for 2002 (see Tables 9 and 10).[5] That increase would be similar to the 7.2 percent jump in discretionary budget authority that occurred between 2001 and 2002.

The increase in discretionary budget authority proposed for 2003 would also approach the annual rate of growth experienced during the 1998–2002 period, which averaged 7.6 percent. However, it would be significantly higher than the average growth rate from 1994 through 1998: 0.8 percent. For the 2003–2012 period, the President proposes to hold the growth rate of discretionary budget authority to 2.8 percent. In CBO's baseline, which assumes that discretionary spending grows at the rate of inflation, budget authority rises at an average annual rate of 2.6 percent.

Discretionary outlays will total $731 billion this year, CBO anticipates, if no further legislation is enacted that affects 2002. Under the President's budget, discretionary outlays would rise to $784 billion next year.

National Defense. The largest proposed increase for 2003 is for defense. The President's budget would add $45 billion in discretionary budget authority for defense programs, or 13 percent—the fastest growth since the defense buildup of the early 1980s. It would bring defense outlays up to 3.5 percent of GDP in 2003, the highest level since 1995. (During the 1980s, defense spending averaged close to 6 percent of GDP.) Included in that request is $10 billion designated as a "wartime contingency" for combating terrorism in Afghanistan or other, as-yet-unspecified, locations; that amount is not requested for later years. After 2003, the President's budget envisions much slower growth of budget authority for defense—an average annual rate of 3.2 percent through 2012.

Nondefense Programs. The President is proposing a much smaller increase—about 1 percent—in appropriations for nondefense activities in 2003. Excluding funds for homeland security (as classified by the Administration), such spending would decline by approximately 1 percent under the President's budget. To accomplish that, the President proposes reductions in programs related to community and regional development, the administration of justice, natural resources and the envi-

[5] 5. All amounts discussed in this section exclude the Administration's proposal that Federal agencies pay the full share of accruing civilian employees' pensions and annuitants' health benefits. That proposal is discussed below.

ronment, agriculture, and commerce. Appropriations for other budget functions, such as energy and general government, would not keep pace with inflation.

The President recommends increasing discretionary spending for some budget functions in 2003. For example, budget authority for veterans benefits and services would grow by about 7 percent, with most of that going for medical care. Budget authority for transportation programs would rise by about 8 percent, primarily for the Coast Guard and the new Transportation Security Administration.

The total budgetary resources available for transportation programs, however, would decline under the President's budget. Obligation limitations, which are not counted as budget authority, control the majority of transportation spending. Consistent with the current authorizing law, those limitations would decline by 21 percent in 2003 in the President's budget (the first decrease since the mid-1990s).[6] The President proposes to curb transportation spending to the point that by 2012, obligation limitations would be lower, in nominal terms, than the level enacted for 2002.

Homeland Security. Since September 11, the President and the Congress have provided additional budgetary resources for homeland security. The Administration estimates that nearly $27 billion in discretionary budget authority will be devoted to homeland security in 2002—$18 billion from the 13 regular appropriation acts and another $8 billion from the Department of Defense and Emergency Supplemental Appropriations for Recovery from and Response to Terrorist Attacks on the United States Act, 2002 (P.L. 107–117).[7]

For 2003, the President proposes $36 billion in discretionary budget authority for homeland security, $10 billion of which would go to defense agencies. Among nondefense departments and agencies, the President's budget proposes funding for homeland security of almost $8 billion for the Department of Transportation, more than $7 billion for the Department of Justice, more than $4 billion for the Department of Health and Human Services, and $3.5 billion for the Federal Emergency Management Agency.

Funding for homeland security is spread among roughly 40 budget subfunctions and at least 100 appropriation accounts. Because most of that spending is included within larger accounts, it is difficult to reestimate or project the effects of increased homeland security funding in the absence of more detailed information from the Administration.

Accrual Accounting for Federal Employees' Benefits. Another request in the President's budget that would affect discretionary spending is the proposal that Federal agencies pay the full cost of their employees' retirement and retiree health benefits as such benefits accrue. Currently, the government's costs of retirement benefits for military personnel and for civilian employees covered by the Federal Employees Retirement System are financed through accrual charges paid from the appropriations of the employing agency. However, the costs of other retirement programs are covered through a combination of agency payments and appropriations. Similarly, although next year the military will begin paying the full accrual costs of its health benefits for future retirees age 65 or older, civilian annuitants health benefits are financed through mandatory spending.

This proposal would not change the promised benefits to retirees or the contributions made by employees and annuitants, so it would not have any net effect on the budget. However, it would raise discretionary spending by roughly $9 billion in 2003, with an equal amount of offsetting receipts recorded on the mandatory side of the budget, if agency appropriations are increased to accommodate the new accrual charges.

Policy Proposals Affecting Mandatory Spending

The President's proposals would add $436 billion to mandatory spending over the 2003–2012 period, CBO estimates (excluding the proposal that Federal agencies pay the full cost of their employees benefits as such benefits accrue). Policy initiatives involving Medicare, refundable tax credits, and agriculture account for about 69 percent of that increase (see Table 11).

Medicare. The President's budget includes several major proposals that would increase outlays for Medicare by nearly $170 billion over 10 years. The bulk of that

[6] 6. The current surface transportation authorizing law, known as TEA–21, specifies that adjustments to obligation limitations for highway spending should be made to reflect changes in the estimates of highway tax revenues. (The law resulted in a large increase in such spending authority for 2002 but calls for a large decrease in 2003.)

[7] 7. For 2002, the Administration also estimates mandatory spending for homeland security at $1 billion (for total budget authority of $28 billion, including discretionary appropriations); in the President's budget, such mandatory spending increases to $2 billion for 2003 (for a total of $38 billion). Some of the spending for homeland security is offset by fees, which amount to $3 billion in 2002 and $5 billion in 2003.

spending comes from a Medicare modernization initiative intended to restructure aspects ofthe program and provide coverage of outpatient prescription drugs beginning in 2006. The Administration estimates that the initiative would cost a total of $116 billion through 2012; however, the budget does not provide enough details of the proposal for CBO to make its own estimate.

Another proposal involves allowing states to provide prescription drug benefits to qualifying Medicare beneficiaries through their Medicaid programs. The Federal portion of Medicaid would reimburse the States for the cost of the program, and Medicare would reimburse Medicaid. CBO estimates that the benefit would cost $57 billion between 2003 and 2012.[8] The Administration has also proposed boosting payments to Medicare+Choice plans and encouraging participation by alternative managed care arrangements. Those proposals would cost $3 billion over the 2003–2012 period, CBO estimates.

The President's budget also contains several proposals that would reduce Medicare spending during the next 10 years. They include creating a nationwide competitive-bidding system that would encourage companies to sell durable medical equipment at lower prices than Medicare currently pays, adding two high-deductible supplemental insurance (medigap) plans to provide a catastrophic coverage option for Medicare beneficiaries, and requiring that insurers and group health plans periodically report to Medicare those beneficiaries for whom Medicare could be the secondary payer. In total, those initiatives would save about $7 billion over the 2003–2012 period, CBO estimates.

Other Health-Related Proposals. Under the President's budget, a new refundable tax credit for the purchase of health insurance would be available to certain people under age 65 who are not covered by their employer or a public program. The credit would subsidize part of their health insurance premiums, up to a specified ceiling. The Administration estimates that the credit would result in $60 billion in outlays (and a reduction of $29 billion in revenues) from 2003 through 2012. JCT has not completed its analysis of the proposal, so the budget projections in this testimony include the Administration's estimate.

The President has also proposed shifting the costs associated with providing health care for uniformed retirees and their dependents under age 65 to the same trust fund that covers health care costs for retirees 65 and older. Currently, those costs are paid from annual appropriations, which are discretionary. The net effect of this proposal on total outlays would be minimal.

Other Initiatives. The Administration's budget would increase spending for agriculture, food, and nutrition programs by $72 billion over the next decade. However, with the exception of proposals that affect the Food Stamp program, the budget offers little detail of the proposed changes. As a result, CBO used the Administration's estimates for all but the Food Stamp portion of those changes.

The President's budget also includes an economic stimulus plan that the Administration says would boost outlays by $27 billion in 2002 and $9.5 billion in the following two years. In addition, the plan would decrease revenues through the middle of the decade and produce increases thereafter. Again, CBO and JCT did not have enough specific information about the plan to produce an independent estimate of its effects on outlays and revenues.

The President has proposed restructuring unemployment compensation so that States would be responsible for their administrative costs. Currently, the Congress appropriates money from the unemployment insurance trust fund to cover those costs, which are recorded on the discretionary side of the budget. Under this proposal, States would pay those costs directly from their State benefit accounts in the Federal unemployment trust fund and would be responsible for generating enough revenues from State unemployment taxes to cover those costs. The income and outlays related to the proposal would appear in the Federal budget. CBO estimates that the change would increase mandatory outlays by $19 billion over the next 10 years and reduce discretionary spending by a corresponding amount below what it otherwise would be. (The policy would also reduce revenues.) In addition, the President has proposed making it easier for States to extend unemployment benefits during an economic downturn, which would cost $0.3 billion over the 2003–2012 period, CBO estimates.

A proposal that would not substantially increase outlays above baseline levels but is nevertheless significant budgetarily is the extension of the Temporary Assistance for Needy Families (TANF) program. As it must by law, CBO's baseline assumes that TANF will continue when its authorization expires at the end of this year. The

[8] 8. Because the budget and other information from the Administration provide only the broad outlines of the proposal, CBO's estimate is necessarily preliminary and may change depending on how important details are clarified.

President's budget explicitly requests reauthorization of the program, with funding at $16.5 billion per year. In addition, the budget proposes changes to TANF—including reauthorizing two elements of the program that expired in 2001—that would add about $350 million in new spending each year.

Policy Proposals Affecting Revenues

The President proposes a number of changes to tax law that would reduce revenues. Those changes involve extensions of certain tax cuts that are scheduled to expire within the next 10 years as well as new revenue-reducing provisions. CBO and JCT estimate that the proposals would lower revenues by a total of $602 billion over the 2003–2012 period and increase outlays by $80 billion (by increasing refundable tax credits). Over 60 percent of the reduction in revenues would occur in the last two years, 2011 and 2012, largely from the proposed extension of the tax cuts enacted last year that are now scheduled to expire at the end of 2010.

The President's proposal to provide economic stimulus through unspecified policies would decrease revenues by $62 billion in 2002 and $65 billion in 2003, according to the Administration. (As noted earlier, CBO and JCT were unable to independently estimate that proposal because no detail was provided in the budget.) Over the 10-year period, the proposal is assumed to lead to a net reduction in revenues of $44 billion.

The President has also proposed providing a refundable tax credit for certain health insurance premiums; permanently extending the research and experimentation credit, which is set to expire in 2004; allowing taxpayers who do not itemize their deductions to deduct a certain amount of charitable contributions from their taxable income; and providing an enhanced deduction for some long-term care insurance (see Table 11). Other proposals that would reduce revenues include providing a tax credit for developers of affordable single-family housing, altering the way in which the unemployment insurance program is financed, and allowing unused amounts in flexible spending arrangements for health care to be carried forward in some circumstances.

Differences Between CBO's and the Administration's Estimates of Policy Proposals

For the President's revenue proposals, CBO's and the Administration's estimates are quite similar. CBO estimates that those proposals would lower revenues by $602 billion over the 2003–2012 period—only $11 billion more than the Administration projects. The difference in estimates does not exceed $2 billion for any year except 2011. For that year, the estimates differ by $7 billion, an insignificant amount given the large changes in tax law and taxpayers behavior that are expected to result from extending the tax-cut provisions that expire at the end of 2010.

On the outlay side, there are also few major differences between CBO and the Administration. In the case of some of the President's new policies for mandatory spending—such as proposals for economic stimulus, modernization of Medicare, refundable tax credits for health insurance, and farm programs—the budget lacks sufficient information for CBO to estimate their costs. In such cases, CBO used the Administration's estimates.

When proposals for savings lacked enough specificity for an independent estimate, CBO did not include their potential budgetary impact, although it did so for proposals that involve new spending. The President's budget includes savings of $18 billion over the 2003–2012 period from a proposal that would change the measure of drug prices used to calculate the rebate that durg manufactures pay under Medicaid. However, the proposal is unclear about how it would treat generic drugs and how it would change the portion of the rebate program that holds the growth of prices for brand-name drugs to the rate of inflation. Without such details, CBO had insufficient basis for estimating savings from the proposal.

Table 1.
Projected Surpluses in CBO's Baseline and in Its Estimate of the President's Budget for 2003
(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
CBO's Estimate of the President's Budget													
On-Budget Surplus or Deficit (-)	-248	-297	-245	-187	-178	-173	-171	-152	-145	-154	-100	-1,079	-1,801
Off-Budget Surplus	157	176	194	211	225	240	256	271	287	304	318	1,046	2,482
Total Surplus or Deficit (-)	-90	-121	-51	24	48	68	85	119	142	150	218	-33	681
CBO's Baseline													
On-Budget Surplus or Deficit (-)	-152	-170	-133	-100	-90	-65	-43	-8	21	150	335	-558	-102
Off-Budget Surplus	157	176	194	211	226	241	256	271	287	304	318	1,047	2,483
Total Surplus	5	6	61	111	135	175	213	263	309	454	653	489	2,380
Difference (President's budget minus baseline)													
On-Budget Surplus or Deficit	-96	-127	-112	-87	-88	-107	-128	-144	-166	-304	-435	-521	-1,699
Off-Budget Surplus	*	*	*	*	*	*	*	*	*	*	*	-1	-1
Total Surplus or Deficit	-96	-128	-112	-87	-88	-107	-128	-144	-166	-304	-435	-522	-1,699

SOURCE: Congressional Budget Office.

NOTE: * = between -$500 million and $500 million.

Table 2.
CBO's Estimate of the President's Budget for 2003

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
In Billions of Dollars														
Revenues														
On-budget	1,484	1,424	1,467	1,576	1,712	1,811	1,899	2,003	2,115	2,224	2,340	2,465	8,466	19,613
Off-budget	508	518	545	574	602	631	661	693	727	764	803	842	3,014	6,842
Total	1,991	1,942	2,013	2,150	2,314	2,442	2,560	2,695	2,842	2,988	3,143	3,307	11,479	26,455
Outlays														
Discretionary spending	649	739	793	816	839	860	883	915	941	970	997	1,015	4,191	9,028
Mandatory spending	1,008	1,125	1,161	1,186	1,250	1,334	1,413	1,501	1,593	1,694	1,822	1,909	6,343	14,862
Net interest	206	169	180	199	202	200	197	195	189	182	174	166	978	1,884
Total	1,864	2,033	2,134	2,201	2,291	2,394	2,493	2,610	2,723	2,846	2,993	3,089	11,512	25,774
On-budget	1,517	1,672	1,764	1,821	1,899	1,989	2,072	2,174	2,267	2,369	2,494	2,564	9,545	21,414
Off-budget	347	361	370	380	392	406	421	436	456	477	499	525	1,967	4,360
Surplus or Deficit														
On-budget	-34	-248	-297	-245	-187	-178	-173	-171	-152	-145	-154	-100	-1,079	-1,801
Off-budget	161	157	176	194	211	225	240	256	271	287	304	318	1,046	2,482
Total	127	-90	-121	-51	24	48	68	85	119	142	150	218	-33	681
Debt Held by the Public	3,320	3,453	3,587	3,650	3,641	3,608	3,552	3,479	3,370	3,238	3,096	2,885	n.a.	n.a.
Memorandum:														
Gross Domestic Product	10,149	10,406	10,940	11,556	12,168	12,803	13,468	14,166	14,897	15,664	16,469	17,314	60,935	139,445
As a Percentage of GDP														
Revenues														
On-budget	14.6	13.7	13.4	13.6	14.1	14.1	14.1	14.1	14.2	14.2	14.2	14.2	13.9	14.1
Off-budget	5.0	5.0	5.0	5.0	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Total	19.6	18.7	18.4	18.6	19.0	19.1	19.0	19.0	19.1	19.1	19.1	19.1	18.8	19.0
Outlays														
Discretionary spending	6.4	7.1	7.3	7.1	6.9	6.7	6.6	6.5	6.3	6.2	6.1	5.9	6.9	6.5
Mandatory spending	9.9	10.8	10.6	10.3	10.3	10.4	10.5	10.6	10.7	10.8	11.1	11.0	10.4	10.7
Net interest	2.0	1.6	1.6	1.7	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.0	1.6	1.4
Total	18.4	19.5	19.5	19.0	18.8	18.7	18.5	18.4	18.3	18.2	18.2	17.8	18.9	18.5
On-budget	14.9	16.1	16.1	15.8	15.6	15.5	15.4	15.3	15.2	15.1	15.1	14.8	15.7	15.4
Off-budget	3.4	3.5	3.4	3.3	3.2	3.2	3.1	3.1	3.1	3.0	3.0	3.0	3.2	3.1
Surplus or Deficit														
On-budget	-0.3	-2.4	-2.7	-2.1	-1.5	-1.4	-1.3	-1.2	-1.0	-0.9	-0.9	-0.6	-1.8	-1.3
Off-budget	1.6	1.5	1.6	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.7	1.8
Total	1.3	-0.9	-1.1	-0.4	0.2	0.4	0.5	0.6	0.8	0.9	0.9	1.3	-0.1	0.5
Debt Held by the Public	32.7	33.2	32.8	31.6	29.9	28.2	26.4	24.6	22.6	20.7	18.8	16.7	n.a.	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

Table 3.
Changes Since January in CBO's Economic Forecast for Calendar Years 2001 Through 2003

	Estimate 2001	Forecast 2002	2003
Nominal GDP (Billions of dollars)			
CBO January	10,193	10,422	11,063
CBO March	10,206	10,521	11,092
Nominal GDP (Percentage change)			
CBO January	3.2	2.2	6.1
CBO March	3.4	3.1	5.4
Real GDP (Percentage change)			
CBO January	1.0	0.8	4.1
CBO March	1.2	1.7	3.4
Tax Bases (Percentage of GDP)			
Corporate book profits			
CBO January	6.9	6.1	7.0
CBO March	7.1	6.9	7.2
Wages and salaries			
CBO January	50.0	50.3	50.1
CBO March	50.0	49.8	49.9
Tax Bases (Billions of dollars)			
Corporate book profits			
CBO January	705	631	774
CBO March	720	730	803
Wages and salaries			
CBO January	5,097	5,243	5,538
CBO March	5,098	5,243	5,538

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: Percentage changes are year over year.

Table 4.
Comparison of CBO's, the Administration's, and Private Economic Projections for Calendar Years 2001 Through 2012

	Estimate	Forecast		Projected Annual Average	
	2001	2002	2003	2004-2007	2008-2012
Nominal GDP (Billions of dollars)					
CBO	10,206	10,521	11,092	13,639[a]	17,532[b]
Administration	10,197	10,481	11,073	13,614[a]	17,404[b]
Nominal GDP (Percentage change)					
CBO	3.4	3.1	5.4	5.3	5.1
Administration	3.3	2.8	5.6	5.3	5.0
February *Blue Chip*	n.a.	2.9	5.4	n.a.	n.a.
Real GDP (Percentage change)					
CBO	1.2	1.7	3.4	3.2	3.1
Administration	1.0	0.7	3.8	3.4	3.1
February *Blue Chip*	n.a.	1.5	3.5	n.a.	n.a.
GDP Price Index (Percentage change)					
CBO	2.2	1.4	2.0	2.0	2.0
Administration	2.3	2.0	1.8	1.8	1.9
February *Blue Chip*	n.a.	1.4	1.8	n.a.	n.a.
Consumer Price Index[c] (Percentage change)					
CBO	2.9	1.8	2.5	2.5	2.5
Administration	2.9	1.8	2.2	2.4	2.3
February *Blue Chip*	n.a.	1.5	2.4	n.a.	n.a.
Unemployment Rate (Percent)					
CBO	4.8	6.1	5.9	5.2	5.2
Administration	4.8	5.9	5.5	5.0	4.9
February *Blue Chip*	n.a.	6.0	5.6	n.a.	n.a.
Three-Month Treasury Bill Rate (Percent)					
CBO	3.4	2.2	4.5	4.9	4.9
Administration	3.4	2.2	3.5	4.2	4.3
February *Blue Chip*	n.a.	2.1	3.4	n.a.	n.a.
Ten-Year Treasury Note Rate (Percent)					
CBO	5.0	5.0	5.5	5.8	5.8
Administration	5.0	5.1	5.1	5.2	5.3
February *Blue Chip*	n.a.	5.1	5.6	n.a.	n.a.
Tax Bases (Percentage of GDP)					
Corporate book profits					
CBO	7.1	6.9	7.2	7.9	8.1
Administration	6.9	7.0	7.7	8.3	8.3
Wages and salaries					
CBO	50.0	49.8	49.9	49.3	48.9
Administration	50.0	50.1	49.8	49.6	49.2

(Continued)

Table 4.
Continued

	Estimate	Forecast		Projected Annual Average	
	2001	2002	2003	2004-2007	2008-2012
Tax Bases (Billions of dollars)					
Corporate book profits					
CBO	720	730	803	1,101[a]	1,425[b]
Administration	706	733	848	1,136[a]	1,419[b]
Wages and salaries					
CBO	5,098	5,243	5,538	6,695[a]	8,565[b]
Administration	5,100	5,246	5,519	6,730[a]	8,549[b]
Corporate Economic Profits[d] (Percentage change)					
CBO	-14.9	2.0	9.0	8.4	5.2
February *Blue Chip*	n.a.	2.2	8.6	n.a.	n.a.

SOURCES: Congressional Budget Office; Office of Management and Budget; Aspen Publishers, Inc., *Blue Chip Economic Indicators* (February 10, 2002); Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

NOTES: Percentage changes are year over year.

n.a. = not applicable.

a. Level in 2007.

b. Level in 2012.

c. The consumer price index for all urban consumers.

d. Book profits and economic profits account for inventories and depreciation of capital in different ways. Book profits are the relevant measure for tax purposes, but economic profits are a better measure of profits from current production.

Table 5.
CBO's Baseline Budget Projections

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007[a]	Total, 2003-2012[a]
						In Billions of Dollars								
Revenues														
Individual income taxes	994	952	1,001	1,059	1,114	1,162	1,228	1,305	1,387	1,477	1,673	1,841	5,565	13,248
Corporate income taxes	151	197	187	202	235	246	260	275	289	303	319	335	1,130	2,650
Social insurance taxes	694	710	748	789	831	869	908	948	995	1,046	1,098	1,152	4,145	9,383
Other	152	147	150	159	162	171	173	179	187	183	189	224	814	1,776
Total	1,991	2,006	2,086	2,209	2,342	2,448	2,569	2,707	2,858	3,009	3,279	3,551	11,654	27,057
On-budget	1,484	1,488	1,540	1,636	1,740	1,817	1,908	2,015	2,131	2,245	2,476	2,708	8,640	20,214
Off-budget	508	518	545	574	602	631	661	693	727	764	803	842	3,014	6,842
Outlays														
Discretionary spending	649	731	761	784	806	822	840	864	886	908	935	951	4,013	8,557
Mandatory spending	1,102	1,194	1,251	1,292	1,359	1,426	1,505	1,598	1,696	1,803	1,927	2,019	6,833	15,876
Offsetting receipts	-93	-91	-102	-112	-118	-114	-120	-127	-133	-141	-149	-157	-567	-1,274
Net interest	206	167	170	184	183	178	170	159	146	131	112	85	884	1,517
Total	1,864	2,001	2,080	2,148	2,231	2,312	2,394	2,494	2,594	2,701	2,825	2,898	11,164	24,677
On-budget	1,517	1,640	1,710	1,769	1,839	1,907	1,973	2,058	2,139	2,223	2,326	2,373	9,198	20,317
Off-budget	347	361	370	379	391	406	420	436	456	477	499	525	1,966	4,360
Surplus or Deficit (-)	127	5	6	61	111	135	175	213	263	309	454	653	489	2,380
On-budget	-34	-152	-170	-133	-100	-90	-65	-43	-8	21	150	335	-558	-102
Off-budget	161	157	176	194	211	226	241	256	271	287	304	318	1,047	2,483
Debt Held by the Public	3,320	3,355	3,361	3,314	3,219	3,099	2,938	2,739	2,489	2,193	1,750	1,107	n.a.	n.a.
Memorandum:														
Gross Domestic Product	10,149	10,406	10,940	11,556	12,168	12,803	13,468	14,166	14,897	15,664	16,469	17,314	60,935	139,445
						As a Percentage of GDP								
Revenues														
Individual income taxes	9.8	9.2	9.2	9.2	9.2	9.1	9.1	9.2	9.3	9.4	10.2	10.6	9.1	9.5
Corporate income taxes	1.5	1.9	1.7	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Social insurance taxes	6.8	6.8	6.8	6.8	6.8	6.8	6.7	6.7	6.7	6.7	6.7	6.7	6.8	6.7
Other	1.5	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.2	1.1	1.3	1.3	1.3
Total	19.6	19.3	19.1	19.1	19.2	19.1	19.1	19.1	19.2	19.2	19.9	20.5	19.1	19.4
On-budget	14.6	14.3	14.1	14.2	14.3	14.2	14.2	14.2	14.3	14.3	15.0	15.6	14.2	14.5
Off-budget	5.0	5.0	5.0	5.0	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Outlays														
Discretionary spending	6.4	7.0	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.5	6.6	6.1
Mandatory spending	10.9	11.5	11.4	11.2	11.2	11.1	11.2	11.3	11.4	11.5	11.7	11.7	11.2	11.4
Offsetting receipts	-0.9	-0.9	-0.9	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Net interest	2.0	1.6	1.6	1.6	1.5	1.4	1.3	1.1	1.0	0.8	0.7	0.5	1.5	1.1
Total	18.4	19.2	19.0	18.6	18.3	18.1	17.8	17.6	17.4	17.2	17.2	16.7	18.3	17.7
On-budget	14.9	15.8	15.6	15.3	15.1	14.9	14.7	14.5	14.4	14.2	14.1	13.7	15.1	14.6
Off-budget	3.4	3.5	3.4	3.3	3.2	3.2	3.1	3.1	3.1	3.0	3.0	3.0	3.2	3.1
Surplus or Deficit (-)	1.3	*	0.1	0.5	0.9	1.1	1.3	1.5	1.8	2.0	2.8	3.8	0.8	1.7
On-budget	-0.3	-1.5	-1.5	-1.2	-0.8	-0.7	-0.5	-0.3	-0.1	0.1	0.9	1.9	-0.9	-0.1
Off-budget	1.6	1.5	1.6	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.7	1.8
Debt Held by the Public	32.7	32.2	30.7	28.7	26.5	24.2	21.8	19.3	16.7	14.0	10.6	6.4	n.a.	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable; * = between zero and 0.05 percent.

a. Numbers in the second half of the table are shown as a percentage of total GDP for this period.

Table 6.
Changes in CBO's Baseline Projections of the Surplus Since January 2002 (In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Total Surplus or Deficit (-) as Projected in January 2002	-21	-14	54	103	128	166	202	250	294	439	641	437	2,263
Changes to Revenue Projections													
Legislative	0	0	0	0	0	0	0	0	0	0	0	0	0
Economic	23	15	3	0	0	0	0	0	0	0	0	18	18
Technical	*	*	*	*	*	1	1	1	1	2	2	2	9
Total Revenue Changes	23	15	3	*	*	1	1	1	1	2	2	20	27
Changes to Outlay Projections													
Legislative													
Discretionary	0	0	0	0	0	0	0	0	0	0	0	0	0
Mandatory	*	*	1	1	1	1	1	1	1	1	1	4	10
Debt service	*	*	*	*	*	*	*	*	*	1	1	*	3
Subtotal, legislative	*	*	1	1	1	1	1	1	2	2	2	5	12
Economic (Debt service)	*	-1	-2	-2	-2	-3	-3	-3	-3	-3	-3	-11	-26
Technical													
Discretionary	-2	-3	*	-1	-2	-2	-2	-2	-2	-2	-2	-8	-18
Mandatory													
Medicare	-1	-2	-3	-6	-6	-7	-9	-10	-12	-12	-10	-25	-78
Medicaid	3	2	2	2	2	2	2	2	2	2	2	10	21
Debt service	*	*	-1	-1	-1	-2	-2	-3	-4	-5	-5	-5	-25
Other	-3	-2	-1	*	2	2	3	3	4	5	6	2	24
Subtotal, mandatory	*	-2	-3	-5	-4	-5	-6	-8	-10	-10	-7	-18	-59
Subtotal, technical	-2	-4	-3	-6	-6	-7	-8	-10	-12	-12	-9	-26	-76
Total Outlay Changes	-3	-5	-4	-7	-7	-8	-9	-12	-13	-13	-10	-32	-90
Total Impact on the Surplus	26	20	8	8	8	9	10	13	15	15	12	52	117
Total Surplus as Projected in March 2002	5	6	61	111	135	175	213	263	309	454	653	489	2,380
Memorandum:													
Total Legislative Changes	*	*	-1	-1	-1	-1	-1	-1	-2	-2	-2	-5	-12
Total Economic Changes	23	16	5	2	2	3	3	3	3	3	3	29	44
Total Technical Changes	2	5	4	6	6	8	9	11	13	13	10	28	85

SOURCE: Congressional Budget Office.

NOTE: * = between -$500 million and $500 million.

Table 7.
Comparison of CBO's March 2002 Baseline and OMB's February 2002 Current-Services Baseline
(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
						CBO's March 2002 Baseline							
Revenues	2,006	2,086	2,209	2,342	2,448	2,569	2,707	2,858	3,009	3,279	3,551	11,654	27,057
On-budget	1,488	1,540	1,636	1,740	1,817	1,908	2,015	2,131	2,245	2,476	2,708	8,640	20,214
Off-budget	518	545	574	602	631	661	693	727	764	803	842	3,014	6,842
Outlays													
Discretionary	731	761	784	806	822	840	864	886	908	935	951	4,013	8,557
Mandatory	1,103	1,148	1,180	1,241	1,312	1,385	1,471	1,562	1,662	1,778	1,862	6,267	14,602
Net interest	167	170	184	183	178	170	159	146	131	112	85	884	1,517
Total	2,001	2,080	2,148	2,231	2,312	2,394	2,494	2,594	2,701	2,825	2,898	11,164	24,677
On-budget	1,640	1,710	1,769	1,839	1,907	1,973	2,058	2,139	2,223	2,326	2,373	9,198	20,317
Off-budget	361	370	379	391	406	420	436	456	477	499	525	1,966	4,360
Surplus	5	6	61	111	135	175	213	263	309	454	653	489	2,380
On-budget	-152	-170	-133	-100	-90	-65	-43	-8	21	150	335	-558	-102
Off-budget	157	176	194	211	226	241	256	271	287	304	318	1,047	2,483
						OMB's February 2002 Current-Services Baseline							
Revenues	2,011	2,121	2,234	2,366	2,461	2,581	2,710	2,847	3,008	3,240	3,502	11,764	27,072
On-budget	1,495	1,574	1,662	1,758	1,827	1,915	2,013	2,119	2,241	2,434	2,659	8,735	20,201
Off-budget	515	547	573	608	635	666	697	728	767	806	843	3,029	6,871
Outlays													
Discretionary	732	759	782	801	816	832	853	874	895	920	935	3,991	8,467
Mandatory	1,111	1,145	1,182	1,242	1,305	1,374	1,458	1,546	1,641	1,751	1,818	6,249	14,464
Net interest	177	175	178	174	168	160	150	138	124	106	82	855	1,455
Total	2,020	2,080	2,142	2,218	2,289	2,366	2,462	2,558	2,659	2,777	2,835	11,095	24,386
On-budget	1,660	1,712	1,764	1,826	1,883	1,944	2,022	2,097	2,173	2,267	2,298	9,129	19,985
Off-budget	360	368	378	391	406	422	440	462	486	510	538	1,965	4,401
Surplus	-9	41	92	148	172	215	247	289	350	464	667	669	2,686
On-budget	-165	-138	-103	-69	-56	-29	-9	22	69	167	351	-394	216
Off-budget	156	179	195	217	228	244	257	266	281	297	306	1,063	2,470

(Continued)

Table 7.
Continued

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
						Difference (CBO minus OMB)							
Revenues	-5	-35	-25	-24	-14	-12	-2	10	1	38	49	-110	-15
On-budget	-8	-34	-26	-18	-10	-7	2	12	4	42	50	-95	14
Off-budget	3	-1	1	-6	-4	-5	-4	-1	-3	-4	-1	-15	-28
Outlays													
Discretionary	-1	2	2	5	7	8	11	12	14	15	16	23	90
Mandatory	-8	3	-2	-1	7	10	13	16	21	27	44	17	138
Net interest	-10	-5	6	9	10	9	9	8	7	6	3	29	62
Total	-19	*	6	13	23	27	32	36	42	48	63	70	291
On-budget	-20	-2	4	13	24	29	36	42	51	59	75	68	332
Off-budget	1	2	2	*	-1	-2	-4	-6	-9	-11	-13	1	-41
Surplus	14	-35	-31	-37	-37	-39	-35	-26	-41	-10	-14	-180	-305
On-budget	13	-32	-30	-31	-34	-36	-34	-30	-47	-17	-26	-164	-318
Off-budget	2	-3	-1	-6	-3	-3	-1	5	6	7	12	-16	13

SOURCES: Congressional Budget Office; Office of Management and Budget.

NOTE: * = between -$500 million and $500 million.

Table 8.
Sources of Differences Between CBO's and the Administration's Estimates of the President's Budget
(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
					Administration's Estimate								
Surplus or Deficit (-) Under the President's Budget	-106	-80	-14	61	86	104	113	142	181	178	231	157	1,002
					Sources of Differences Between CBO and the Administration								
Revenue Differences													
Baseline	-5	-35	-25	-24	-14	-12	-2	10	1	38	49	-110	-15
Policy	1	*	*	1	*	1	-1	-2	-1	-7	-2	1	-11
Total	-4	-35	-26	-24	-13	-11	-3	8	-1	32	47	-109	-26
Outlay Differences													
Discretionary	-1	4	1	1	3	3	-2	-1	1	7	1	11	16
Mandatory													
Baseline	-8	3	-2	-1	7	10	13	16	21	27	44	17	138
Policy	-1	*	3	2	4	*	*	1	2	11	1	9	24
Subtotal, mandatory	-9	2	1	1	11	10	13	17	23	38	45	26	162
Net interest	-10	-1	10	11	12	12	14	15	15	15	14	44	117
Total	-20	6	12	14	25	25	25	31	38	60	60	81	296
All Differences	16	-41	-37	-37	-39	-36	-28	-23	-39	-28	-13	-190	-321
					CBO's Estimate								
Surplus or Deficit (-) Under the President's Budget	-90	-121	-51	24	48	68	85	119	142	150	218	-33	681
Memorandum:													
Economic Differences													
Revenues	*	-4	-6	-15	-19	-13	-5	1	7	15	21	-58	-19
Outlays	-1	15	22	23	28	33	41	46	49	53	57	121	367
Total	2	-19	-28	-38	-47	-46	-46	-45	-42	-39	-35	-179	-386
Technical Differences													
Revenues	-4	-31	-19	-8	6	2	2	7	-8	17	26	-51	-6
Outlays	-18	-9	-11	-10	-3	-8	-15	-14	-11	6	3	-40	-71
Total	14	-22	-9	1	9	10	17	22	3	11	23	-11	65

SOURCE: Congressional Budget Office.

NOTE: * = between -$500 million and $500 million.

Table 9.
Discretionary Spending Under the President's Budget and CBO's Baseline Projections
(In billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
CBO's Estimate of Total Discretionary Spending Under the President's Budget[a]														
Budget Authority														
Defense	332	348	393	395	416	436	458	470	482	495	508	521	2,097	4,573
Nondefense	332	364	366	379	385	392	401	412	422	437	442	452	1,923	4,088
Total	664	712	759	774	801	828	859	881	904	932	950	974	4,021	8,661
Outlays														
Defense	306	348	380	388	406	420	434	455	470	484	502	509	2,029	4,449
Nondefense	343	383	404	411	417	423	431	441	452	466	474	485	2,086	4,403
Total	649	731	784	800	823	843	865	896	922	950	976	993	4,115	8,852
CBO's Baseline for Discretionary Spending														
Budget Authority														
Defense	332	348	357	366	376	385	395	406	416	427	438	449	1,879	4,015
Nondefense	332	363	375	385	395	404	415	425	436	448	459	471	1,974	4,213
Total	664	710	732	751	770	790	810	831	853	875	897	920	3,853	8,229
Outlays														
Defense	306	348	354	363	375	380	387	400	411	421	436	439	1,859	3,966
Nondefense	343	383	407	421	432	442	453	464	475	487	499	512	2,154	4,591
Total	649	731	761	784	806	822	840	864	886	908	935	951	4,013	8,557
Memorandum: Administration's Estimates of Discretionary Accrual Payments														
Budget authority														
Defense	n.a.	3	3	10	11	11	12	13	13	14	15	16	47	118
Nondefense	n.a.	5	6	6	6	6	6	6	6	6	6	6	29	58
Total	n.a.	9	9	16	17	17	18	18	19	20	21	22	76	176
Outlays														
Defense	n.a.	3	3	10	11	11	12	13	13	14	15	16	47	118
Nondefense	n.a.	5	6	6	6	6	6	6	6	6	6	6	29	58
Total	n.a.	9	9	16	17	17	18	18	19	20	21	22	76	176

SOURCE: Congressional Budget Office.

NOTE: Discretionary outlays are usually higher than budget authority because of spending from the Highway Trust Fund and the Airport and Airways Trust Fund, which is subject to obligation limitations set in appropriation acts. The budget authority for such programs is provided in authorizing legislation and is not considered discretionary.

a. Excludes the Administration's proposal that federal agencies pay the full share of accruing employees' pensions and annuitants' health benefits. The costs of that proposal appear in the memorandum section of the table.

Table 10.
Comparison of Discretionary Budget Authority Enacted for 2002 and the President's Request for 2003, by Budget Function (In billions of dollars)

Budget Function	2002 Enacted	2003 Request	Increase or Decrease (-) Billions of Dollars	Percent
Defense Discretionary	347.6	392.8	45.2	13.0
Nondefense Discretionary				
International affairs	24.0	25.3	1.3	5.4
General science, space, and technology	21.9	22.4	0.5	2.2
Energy	3.3	3.3	*	1.2
Natural resources and environment	29.0	27.6	-1.4	-4.9
Agriculture	5.6	5.1	-0.5	-8.5
Commerce and housing credit[a]	0.9	-0.1	-0.9	-106.9
Transportation	18.9	20.4	1.5	8.1
Community and regional development	18.4	15.1	-3.2	-17.6
Education, training, employment, and social services	70.3	72.1	1.8	2.5
Health	45.9	48.4	2.5	5.4
Medicare (Administrative costs)	3.6	3.6	*	-0.8
Income security	43.3	45.3	2.0	4.6
Social Security (Administrative costs)	3.5	3.9	0.3	9.4
Veterans benefits and services	23.9	25.6	1.7	7.1
Administration of justice	34.6	32.6	-1.9	-5.6
General government	15.6	15.6	*	0.3
Total, nondefense discretionary	362.7	366.3	3.7	1.0
Total Discretionary	710.3	759.1	48.8	6.9
Memorandum:				
Administration's Estimates				
Accrual payments	8.5	9.0	0.5	5.3
Homeland security	26.5	36.1	9.6	36.4
Transportation obligation limitations	41.1	32.4	-8.7	-21.2

SOURCES: Congressional Budget Office; Office of Management of Budget.

NOTES: The numbers in the main section of the table exclude the Administration's proposal that federal agencies pay the full share of accruing employees' pensions and annuitants' health benefits. The costs of that proposal appear in the memorandum section of the table.

* = between -$50 million and $50 million.

a. Includes certain receipts, such as those from loan guarantees made under the Federal Housing Administration's Mutual Mortgage Insurance Program, and other collections, such as those from the Securities and Exchange Commission, which are recorded as negative budget authority and outlays.

Table 11.
CBO's Estimate of the Effect of the President's Budgetary Proposals (In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
CBO's Baseline Projection of the Surplus	5	6	61	111	135	175	213	263	309	454	653	489	2,380
Effect of the President's Proposals													
Revenues													
Extension of provisions expiring in 2010	0	-1	-1	-2	-2	-3	-3	-3	-4	-115	-219	-9	-353
Extension of research and experimentation tax credit	0	0	-1	-4	-5	-6	-7	-7	-8	-8	-9	-15	-54
Economic stimulus[a]	-62	-65	-48	-10	17	18	15	12	9	6	3	-87	-44
Charitable deductions for non-itemizers	*	-1	-1	-2	-3	-3	-3	-3	-3	-4	-5	-11	-29
Health care tax credit[b]	0	*	-2	-3	-3	-3	-3	-3	-4	-4	-4	-10	-29
Enhanced deduction for long-term care insurance	0	0	*	-1	-1	-2	-3	-3	-3	-4	-4	-4	-20
Other[b]	-2	-5	-7	-7	-8	-10	-8	-7	-7	-7	-6	-37	-73
Subtotal, revenues	-64	-73	-59	-27	-6	-8	-12	-16	-21	-136	-243	-174	-602
Outlays													
Discretionary													
Defense	0	26	25	32	40	47	55	59	63	67	69	170	483
Nondefense	0	-3	-9	-15	-19	-22	-23	-24	-21	-25	-27	-68	-188
Subtotal, discretionary	0	23	16	17	21	25	32	36	42	41	42	102	295
Accruals	9	9	16	17	17	18	18	19	20	21	22	76	176
Subtotal, discretionary with accruals	9	32	32	33	38	43	51	55	62	62	64	178	471
Mandatory													
Medicare[c]	0	2	3	4	16	20	22	23	25	26	28	45	169
Health care tax credit[b]	0	1	5	6	7	6	7	7	7	7	7	25	60
Defense retiree health benefits	0	0	6	6	7	7	8	8	9	9	9	26	69
Farm payments[d]	4	7	7	7	7	7	7	7	7	7	7	36	72
Economic stimulus[a]	27	8	2	0	0	0	0	0	0	0	0	10	10
Unemployment insurance	0	0	0	*	2	3	3	3	3	3	3	5	20
Extension of provisions expiring in 2010	0	0	0	0	0	0	0	0	0	10	10	0	20
Other	*	4	-1	1	*	2	2	2	2	2	2	6	17
Subtotal, mandatory	31	22	22	25	39	46	48	50	53	65	68	153	436
Accruals	-9	-9	-16	-17	-17	-18	-18	-19	-20	-21	-22	-76	-176
Subtotal, mandatory with accruals	22	13	6	9	22	28	29	31	33	44	47	77	260
Net interest	1	10	15	18	22	28	36	43	51	62	81	93	366
Subtotal, outlays	32	55	53	60	82	99	116	129	146	168	191	348	1,098
Total Effect on the Surplus	-96	-128	-112	-87	-88	-107	-128	-144	-166	-304	-435	-522	-1,699
Surplus or Deficit (-) Under the President's Proposals	-90	-121	-51	24	48	68	85	119	142	150	218	-33	681

(Continued)

Table 11.
Continued

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Memorandum:													
CBO's Estimate of the Surplus or Deficit (-) Under the President's Budget Excluding Economic Stimulus	*	-43	8	46	43	62	83	120	146	157	229	116	850

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTES: Estimates of most of the revenue proposals were provided by the Joint Committee on Taxation and are preliminary.

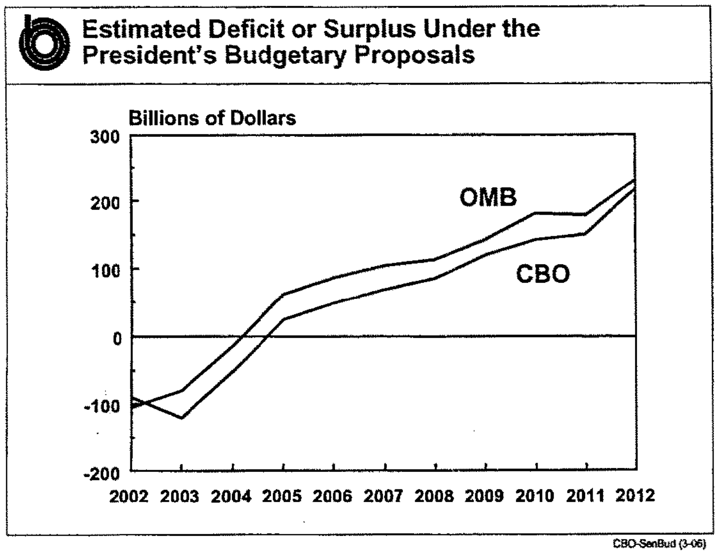
* = between -$500 million and $500 million.

a. Neither CBO nor JCT had sufficient detail to make an independent estimate of this proposal. The estimate shown in the table is the one contained in the President's budget.

b. JCT has not completed its analysis of the proposals for a health care tax credit and for administrative reforms to the Internal Revenue Service. Instead, CBO used the Administration's estimates.

c. CBO did not have enough detail to make an independent estimate of the allowance for modernizing Medicare. Instead, it used the estimate contained in the President's budget. Sufficient information was available for CBO to estimate the remaining Medicare proposals.

d. The only proposal with enough detail for CBO to make an independent estimate involved Food Stamps. For the remaining proposals in this category, CBO used the Administration's estimates.


Estimated Deficit or Surplus Under the President's Budgetary Proposals
Billions of Dollars
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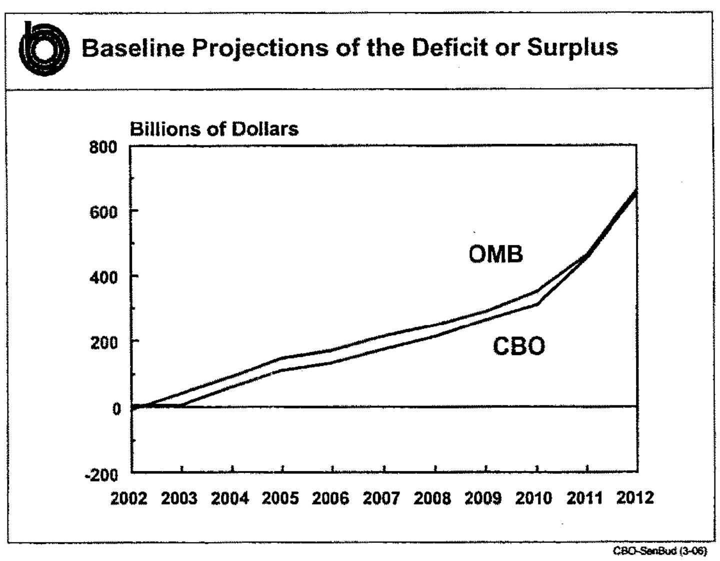
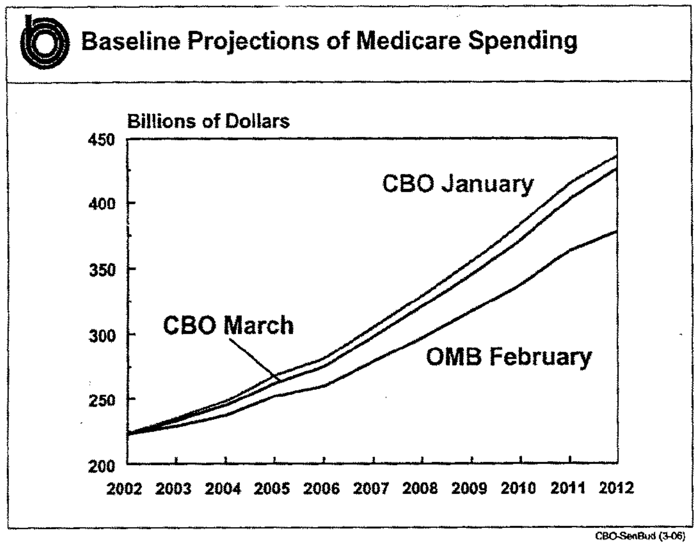
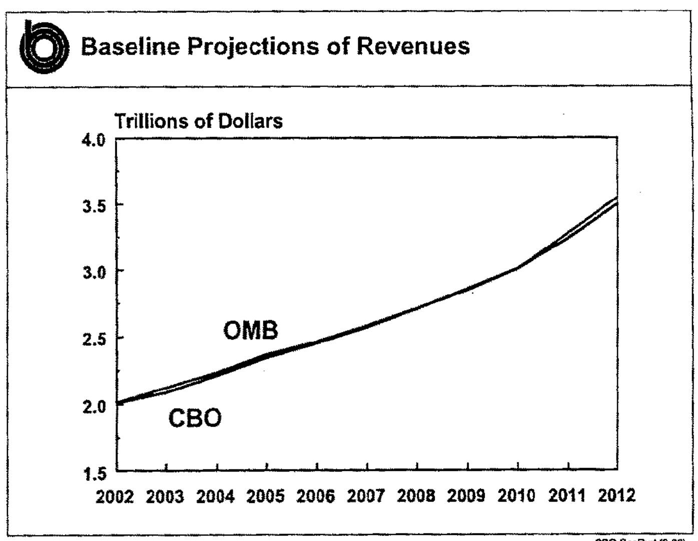
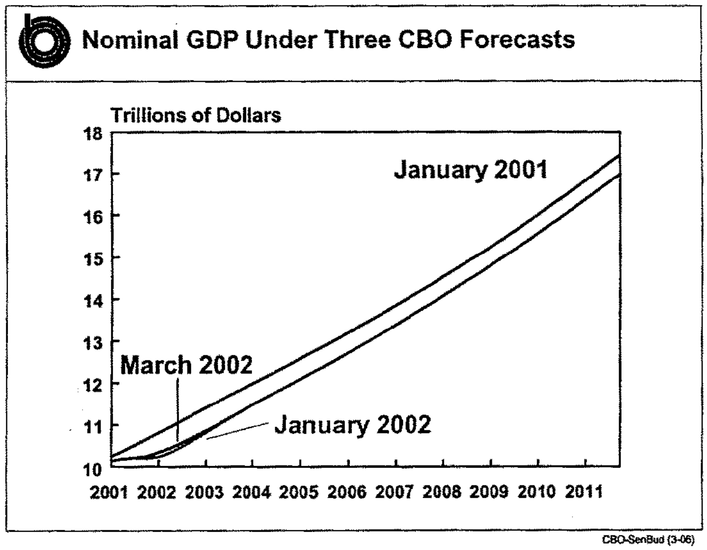
200
100
0
-100
-200
OMB
CBO
2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
CBO-SenBud (3-06)


Baseline Projections of the Deficit or Surplus
Billions of Dollars
800
600
400
200
0
-200
OMB
CBO
2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
CBO-SenBud (3-06)


Baseline Projections of Medicare Spending
Billions of Dollars
450
400
350
300
250
200
2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
CBO January
CBO March
OMB February
CBO-SenBud (3-06)


Baseline Projections of Revenues
Trillions of Dollars
4.0
3.5
3.0
2.5
2.0
1.5
2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
OMB
CBO
CBO-SenBud (3-06)


Nominal GDP Under Three CBO Forecasts
Trillions of Dollars
18
17
16
15
14
13
12
11
10
January 2001
March 2002
January 2002
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011
CBO-SenBud (3-06)

Chairman CONRAD. Thank you, Director Crippen.

My first question to you is: You are showing surpluses of $5 billion for 2002 and $6 billion for 2003, but that does not include the President's budget proposals for those years, does it?

Mr. CRIPPEN. It does not.

Chairman CONRAD. That does not. What would be the result if the President's proposals are adopted for 2002 and 2003?

Mr. CRIPPEN. We estimate, Mr. Chairman, that the combined unified budget would show deficits of $90 billion and $121 billion, respectively, for those 2 years.

Chairman CONRAD. So for 2002, if the President's policies are adopted, it would be a $90 billion deficit, and for 2003, if the President's policies were adopted, according to your best estimates, $121 billion deficit.

Mr. CRIPPEN. Yes.

Chairman CONRAD. But that includes Social Security in the calculation, does it not?

Mr. CRIPPEN. Yes, that is the combined unified deficit that we are talking about.

Chairman CONRAD. What if the Social Security surpluses were excluded? What then would be your conclusions for 2002 and 2003? I believe it is on page 18.

Mr. CRIPPEN. Is it? OK. Thank you. [Laughter.]

Mr. CRIPPEN. If I have page 18.

For 2002 and 2003, if my colleagues can check my arithmetic here—you probably have the numbers as well, Mr. Chairman—it looks like $248 billion and $297 billion of on-budget deficits, respectively, for those 2 years.

Chairman CONRAD. So if we would do what the President—if we would follow the course the President has pledged to follow and virtually every Member of Congress has pledged to do and exclude Social Security from the deficit calculator, the deficits, which would be large under the President's plan in any case, would even be substantially larger, $248 billion in 2002, $297 billion in 2003.

Let me turn just quickly to the Medicare difference, because that is where we see, as you have testified, still a significant difference between the President's estimates and yours with respect to the costs of Medicare over the forecast period.

As I read your analysis, you are telling us that you believe Medicare will cost some roughly $200 billion more over the period than the President's estimates. Can you tell us the reason for that size of difference?

Mr. CRIPPEN. The difference is $225 billion, as I recall, over the 10 years. Much of that is due to how we think non-hospital ancillary services home health care, skilled nursing facilities, and outpatient treatments will be utilized, in terms of both the number of people who avail themselves of those services and the intensity or case mix. We expect more expensive cases, if you will, than the HCFA actuaries believe.

I should say we have had extensive discussions with the actuaries. They are obviously as convinced as we are that they are about in the right ballpark—again, not altogether different from ours. But I would say that we are likely in many areas, but certainly this one, to both be wrong. There are new payment systems going into effect for many of these services, where you have gone from other kinds of restraints—length of stays, numbers of days, all of those things—to more of a package payment or a lump-sum payment. And so neither of us is all that certain how this is going to work.

One of the things that the actuaries have assumed that we haven't is that there is a fair amount of discretion to the Secretary of HHS to make some adjustments in these payments as he or she sees fit in the future. They have assumed that that authority would be used if our numbers were more like the reality that they face come mid-decade, and so there is some assumption about secretarial authority being utilized to lower payments as well. But largely it is a difference in views of how many people will be using the services and at what level of intensity.

Chairman CONRAD. OK. I thank you for that. It is very important that we understand the differences here.

On economic growth, can you tell us what economic growth you are projecting for the current year and next year?

Mr. CRIPPEN. I have anticipated all of your questions.

On a year-over-year basis, we forecast 1.7 percent for 2002 and 3.4 percent for 2003.

Chairman CONRAD. Could you break down the 2002 number for us a little more? The 1.7 percent would be the growth for all of 2002. Could you tell us what you anticipate growth to be for third and fourth quarter?

Mr. CRIPPEN. Let's see. I have the projection for the third quarter at 3.3 percent on an annual basis and for the fourth quarter at 3.3 on an annual basis.

Chairman CONRAD. So fairly health economic growth the second half of this year.

Mr. CRIPPEN. Correct.

Chairman CONRAD. And continuing into next year?

Mr. CRIPPEN. Yes——

Chairman CONRAD. Strong economic growth.

Mr. CRIPPEN. Yes, increasing to 3.4 percent in the first quarter of the next calendar year and growing to 3.6 percent by the fourth quarter.

Chairman CONRAD. Does that include any provision for a stimulus package?

Mr. CRIPPEN. I believe it does not, because these are our baseline economics, and so they do not assume any of the President's policies.

Chairman CONRAD. So you are forecasting a return by third and fourth quarter of this year to strong economic growth without any stimulus package?

Mr. CRIPPEN. That is correct.

Chairman CONRAD. A final question from me. In 2003, what are the differences in revenues between you and the administration? How big is that difference?

Mr. CRIPPEN. I am going to rely on my colleagues to give it to me. It is about a $50 billion difference.

Chairman CONRAD. Fifty billion?

Mr. CRIPPEN. In 2003, it is $35 billion; in 2004, $25 billion.

Chairman CONRAD. So you are projecting in 2002 $35 billion less in revenue than the administration?

Mr. CRIPPEN. In 2002, it is only $5 billon, but in 2003 it is $35 billion.

Chairman CONRAD. In 2003, it is $35 billion. Could you tell us what accounts for most of that difference?

Mr. CRIPPEN. The biggest single item is corporate tax receipts. Our baseline has taxable profits much lower—close to $100 billion lower—than the administration's. CBO's projection of corporate book profits for 2003 is $45 billion lower than the Adminstration's. Or, to think of it another way, we assume a lower effective tax rate on corporate profits than the administration to the tune of about $20 billion. So about two-thirds of it is corporate. The single other largest difference is $8 billion or so in individual income tax receipts. There the question is roughly how many taxpayers will be in the upper-income brackets. We assume fewer such taxpayers in our models and our forecasts than the administration does. But, again, these numbers, while of course important as you work your way around zero of balance or deficit, certainly are very small over the 10 years. We are closer to the administration than we may have ever been, as you can see from the fourth graph that is included in your package in front of you. And even these numbers, while unusually large in the end years, are still small relative to the $2-plus trillion of revenue we are going to be collecting. So it is the equivalent of $35 out of, say, $2,000.

Chairman CONRAD. So, in conclusion, your estimates for 2003, the first year of the budget resolution we would be writing, is that there would be a $6 billion surplus without the President's budget proposals being adopted; if they are adopted, if we would accept the President's spending and revenue proposals, we would face a budget deficit of $121 billion in 2003. Is that correct?

Mr. CRIPPEN. Correct.

Chairman CONRAD. Senator Domenici?

Senator DOMENICI. If one of my Senators on this side desired to proceed, I would rather yield to somebody. I will come back later. Go ahead. One of you should take it because I am not—please.

Senator HAGEL. Dr. Crippen, thank you, as always. As we have listened to your testimony and viewed your numbers represented on the charts, going back into the last couple of years, fiscal year 2000 we had a considerable surplus, as you know, and I think that represented about 2.5 percent of the GDP. My bigger question is, as you have testified this morning, it appears that we are going to come out of fiscal year 2002 and go into fiscal year 2003 roughly at a balanced budget point, and that is at the same time we are fighting a war at considerable expense, somewhere coming out of a recession or in a recession, and we will know more as the numbers develop.

Historically, when we have been at times of recession and certainly when we have had a war with that combination, has the Federal budget been in balance?

Mr. CRIPPEN. Certainly during and since World War II, Korea, and Vietnam, we have had periods where we have increased the public debt and the budget has not been in balance. It has been in deficit during those times.

Senator HAGEL. Why do you think this situation, as it appears is going to be, is different?

Mr. CRIPPEN. Well, for one thing, of course, we don't know yet the costs of conducting of the war we are in. These numbers before you don't anticipate any more supplemental spending or other things we are told are likely to occur. The administration may ask you for some additional defense spending, and, of course, we don't know about the future conduct of the war. So these estimates are relatively conservative (small "c" conservative) about the costs of the conduct of the war and whatever homeland-defense initiatives are necessary, as Dr. Frist and you have both been involved in.

So, in that sense, we may see some larger deficits in the next year or two simply because we haven't anticipated all of the necessary expenditures. But in the main, after we get out of this dip, revenues will continue to grow over this decade and get back up to about 19.5 percent of GDP by the end of the decade, we believe, or somewhere in that neighborhood.

So, in some sense, we will be collecting a significant amount of revenue over the course of this 10 years and therefore have, I suspect, lower deficits than we did. We weren't collecting levels of revenue this high in the run-ups to any of the wars.

Senator HAGEL. Are you surprised, in light of September 11th and the recession dynamic, that, again, it appears that we are now on a upward course here, working our way out of recession? I suspect a good deal of that is a result of some confidence in the economy. Are you surprised by that?

Mr. CRIPPEN. Yes, we have all been surprised. I say that as a member of the economics profession in general, but certainly those of us at CBO expected that the weakened economy that existed before September 11th would be prolonged, if not kicked into a deeper recession, because of the attacks of September 11th. Consumers backed off from a lot of purchases in the first couple of weeks, which is fully understandable, had but they came back strong. And as I said in my testimony, auto sales took off in part because of zero financing, but they and the housing sector continued to be strong throughout this time period.

Consumers have not pulled back. Even the decline in equity markets over the last 6 months of last year has not deterred them, so far, from continuing to spend. And the really encouraging part, I think, of the data we are getting now is that businesses are stepping back up to the plate and beginning not only to generate some profits but probably to invest again, which is where this recession started in the first place.

Senator HAGEL. What do you think is behind the psychology of that?

Mr. CRIPPEN. Well, business, of course, will need to see continued positive consumer sentiment, which they are seeing. I mean, that is being proved every day. Consumers, as I said back in January, have really kept up their end of the deal throughout. Last year, even though we had a weak economy, consumer spending grew by 2.5 percent. It had been 5 percent the year before, so it was a little less, but it was still growing. Inventory depletions, of course, have a limit of zero, and as people continue to consume, corporations are going to have to start using their capacity, and as that happens, there will be more capital investments.

So all of that, plus the apparent reappearance of more corporate profits, suggests that businesses certainly should be back investing in capital again as they were before.

Senator HAGEL. Is there one factor or element, unknown dynamic that concerns you most that is floating around out there in this universe of the unknown as to having an effect that could take us back the other way?

Mr. CRIPPEN. I think the single biggest risk the country faces is further terrorist attacks and whatever the conduct of this war looks like ultimately. That is why these estimates are hard to believe but are even more uncertain or more risky than one would have assumed before September 11th, because consumer confidence (in this case, consumption) is the linchpin of our economy. And anything that would deter that, make people stay home, would be harmful. That is the biggest single risk, I think, in all of our outlooks.

The economy might not grow quite as quickly in the next quarter or two as it would appear at the moment, because there are a few downside risks. But probably will not go back into recession. No one now is thinking much about a so-called double dip. It may be a little weaker than we think, but the only thing that I can think of that would dramatically change this outlook is further terrorist attacks.

Senator HAGEL. Dr. Crippen, thank you.

Mr. Chairman, thank you.

Chairman CONRAD. Thank you, Senator.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman. And welcome again and thank you to you and your staff for your hard work.

Following up on the question of unpredictability or uncertainty and looking throughout your report, you have indicated that the outlook for growth in the coming months is extremely uncertain, and you have listed the mild winter and a number of other issues that come into play regarding cost.

Given the fact that you have revised economic projections in less than 2 months, which we are pleased at the direction in which they are being revised, obviously, but from your perspective as we put together this budget resolution and given the volatility, given the concern, and hopefully we will not see additional terrorist attacks, but certainly there is great concern about that, should we put, in fact, some kind of corruptive mechanism or a trigger mechanism that would put parameters around this budget so that if we are going further into debt, it requires some action by the Congress to come back and revisit our tax and spending policies?

Mr. CRIPPEN. I think that in the next year or two, Senator, unless there is a major surprise out there somewhere (as we hope and pray there is not) we may be off a bit in our estimates of both outlays and revenues, as I suspect OMB is as well. But, at least in our baseline, before we start adopting policies, the bottom line should run roughly at zero. I mean, in January we projected small deficits. We have changed our outlook a little, and now project small surpluses. But that swing is so small that we could say we have a baseline budget (if you didn't do anything else about spending and revenues) that is roughly in balance. And I don't think that outlook will change much in the next year or two. It is certainly the longer term that we all are concerned about, and there our forecasts are very subject to change, and we have emphasized the uncertainty involved. The longer you go, the more uncertainty there is.

In the matter of triggers, that is really a policy question for you all to consider. You have the opportunity, of course, to change law when you want to, with the concurrence of the President, so you have an ongoing trigger mechanism of some kind. But I understand that it may be desirable to have things happen more quickly or automatically. But that really is a policy question. The only thing I would stress is that as economic conditions change, desirable fiscal policy may change. So whereas last January it may have been a good thing to try and pay down debt, in the face of a recession, when we are in it, you may not want quite as aggressive a fiscal policy.

All I am trying to say—and not very articulately—is that the outlook for fiscal policy and what you want to do with it may change over time, depending upon conditions. A trigger mechanism may not be able to anticipate all of those circumstances.

Senator STABENOW. I think the reason for looking at some kind of a trigger is that, as you have indicated, it does change over time, situations change, and, unfortunately, we have locked in policies regarding tax cuts and other spending that, unfortunately, is locked in over a longer period of time, which, in fact, affects us differently depending on the outcome of economic change.

I am wondering if you have done numbers in here that relate to what would happen if, in fact, the tax cut is permanent as we move forward in the next decade.

Mr. CRIPPEN. Yes, we have, Senator, because this 10-year horizon includes a few years after the tax cut is currently scheduled to expire. I am looking now for the approriate table. Maybe Mark has it. We show what happens with expiring tax provisions largely because of the tax cut of last year, and the effect is several hundred billion each year. We will have an exact number here in just a moment.

It is roughly $130 billion in 2011 and $230 billion in 2012.

Senator STABENOW. In deficit?

Mr. CRIPPEN. That is how much revenue——

Senator STABENOW. Are you saying the cost?

Mr. CRIPPEN. That would be the cost of extending the——

Senator STABENOW. So we would add that essentially to the deficit projections.

Mr. CRIPPEN. Yes.

Senator STABENOW. OK. A couple of other questions. When you are looking at Medicare and you speak about home health, do your numbers include the home health care cut of 15 percent that is scheduled to take effect? Or does it assume a delay in that 15 percent cut?

Mr. CRIPPEN. We assume that it goes into effect as it is currently scheduled.

Senator STABENOW. So even though we have, in fact, been delaying that and choosing not to have that go into effect.

Mr. CRIPPEN. Right.

Senator STABENOW. So if the 15 percent cut does not go into effect, these numbers would have to change?

Mr. CRIPPEN. Yes.

Senator STABENOW. OK.

Mr. CRIPPEN. The same is true, by the way—and I testified last week on the House side—on physician payments. Given what you are hearing, I am sure, from your physicians about the likely reduction in fee schedules for the next year or two, we assume those reductions will take place. So if they don't, these numbers will change.

Senator STABENOW. OK. And as someone who is very concerned and would not support that 15 percent cut happening for home health care, it is important for us to know that those numbers change. And when we look at the overall numbers on Table 11, you show the President proposing cutting $188 billion below inflation for non-defense appropriations. And so I am assuming that if we did not institute the home health cut of 15 percent or other reductions in physician services, it would even add more to that number and change that number. But I am assuming the $188 billion below inflation would affect potentially homeland security, border security, education, National Institutes of Health, a wide variety of non-defense efforts that have been prioritized, and I know of which there is great concern that we continue.

I wonder if you would see in your crystal ball, or you would project that this cut would likely happen given the recent trends.

Mr. CRIPPEN. Well, if the recent history is an indicator, then domestic discretionary spending would likely go up more at the end of the day than this budget shows. In looking through briefly what the President has proposed on discretionary—and I expect that number, by the way, wouldn't include Medicare—I mean, it would make—if we delay home health, it will increase the deficit but not discretionary.

But there are a number of things the President does propose to increase in domestic discretionary that I am sure Congress will endorse or be in favor of. Some of it is homeland security, but NIH and other things you just cited do go up. Obviously, in order to come up with a number, there are a number of things that don't go up. In fact, there are some cuts in here. And I can't tell you whether I think those cuts are going to survive or not. Some of them are probably in the nature of one-time expenditures, some coming off, FEMA spending and other things that you may accept as reductions from last year's budget because we had some extraordinary expenditures. But I certainly don't know whether the Congress will be of a mind to endorse this, and it would be probably a pretty good prediction that certainly the President's budget in total won't be adopted.

Senator STABENOW. Thank you.

Chairman CONRAD. Senator Frist.

Senator FRIST. Thank you.

Senator DOMENICI. Senator Frist, I wonder if I could ask a clarifying question on the last——

Senator FRIST. Sure.

Senator DOMENICI. What time do you have to leave?

Senator FRIST. I have got to leave in about 5 minutes, but go ahead.

Senator DOMENICI. Well, you——

Senator FRIST. I will be quick. I just have one central question and that is on the tax cut. For the past several years, the good news on revenues and surplus led to the whole debate over how Congress could allocate the surplus, a debate that we all participated in with varying approaches. Early last year, the news that the economy was slowing seemed to have generated more interest in tax cuts. The President, working with the Congress, was successful in passing tax cuts.

Your numbers that we have talked about today show that the recession has, at least on paper, ended. We still have, I think, a lot to accomplish in terms of jobs and in terms of employment. But the numbers are increasingly encouraging.

Do you think last year's tax cut hastened the end of the recession?

Mr. CRIPPEN. It is very hard to sort, Senator, what contributed. Certainly in our view, and most economists, some of the things that occurred in the tax cut, like the rebates, probably added significantly to consumer income. Now, the first—well, it did add income. The first month or so after the rebate checks went out, we didn't see much in consumption. We saw credit card debt being paid down, things like that, which, of course, is not harmful either in the long run. But it looks like that eventually the rebates and the program did help consumption, so it would have helped end the recession or make it milder, either one.

It is hard to sort out, and not only because we don't have contemporaneous data, but you have things like the auto program with zero financing. We don't know how many of those cars would have been sold next week instead of last month had there not been the zero financing and had there not been the rebates.

So it is always a game, if you will, of constructing what would have happened if we didn't do something, this counterfactual. But our best guess is that it certainly helped either make the recession shorter or shallower than it would have otherwise been because consumption was higher.

Senator FRIST. You stated earlier that most economists believe the latest downturn will take the shape of the typical v-shape curve and not a double-dip shape correct?

Mr. CRIPPEN. Right.

Senator FRIST. Do you think the tax cuts, helped prevent a double?

Mr. CRIPPEN. I think it is hard, but you have through the tax cuts, especially the early rebate program and the lower bracket, created a situation where consumers have more after-tax disposable income and, therefore, consumption should be reinforced because of it. And we have seen exactly that. I mean, consumption has not fallen. Even in the wake of September 11th, consumers are still out there doing their thing. So one has to conclude that it has certainly been very helpful in promoting consumption.

The longer-run effects are equally important, of course, for the longer-run problems we are talking about. And as we suggested last August in our midyear review, we wrote what the macroeconomic effects of the tax cut overall might be. As with any tax bill, there are some positives, there are some negatives. But in the main, we think there will be a small, probably positive effect on economic growth in the long run. But that is mostly due to labor supply responses. There will be more labor supply because of the tax bill. But that effect won't show up in the short run.

A long way around your question, I guess, but the point is we suspect, without a lot of data, that the tax bill, especially the short-run rebates, helped shorten and—make the recession shorter and shallower. And to the extent that is true and consumers keep up their end of this, there won't be a second dip, so it probably helped both of those things.

Senator FRIST. If you look at the spending increases we made last year, do you think that those were helpful in our fiscal and economic outlook?

Mr. CRIPPEN. Probably. Again, consumption includes what the Government does, and the fact that we were consuming more, spending more in construction or clean-up or other things probably helped as well. That is, of course, the classic sort of Keynesian outlook of the world: If you increase Government spending, you could increase overall demand. It is not clear what the relationship is. It is certainly not dollar for dollar, but it probably was helpful.

Senator FRIST. In your first slide, the one that is on the floor there, where you show the estimated deficit or surplus under the President's budgetary proposals, the increase there, how much of that increase—and I know it is difficult to factor out, is a product of the increased spending that will go on as a product of the war itself?

Mr. CRIPPEN. Well, some of the deficit, of course, that you are seeing there is due to current increases in defense spending. But we are going to climb back, out of deficit largely because of increases in revenues largely, and that is because of the end of the recession and stronger economic growth. We show positive surpluses after a couple of years because revenues are going to grow, not because spending has changed a great deal. Is that responsive?

Senator FRIST. That is actually helpful.

In looking at the longer term, what do you think we need to be doing in terms of fiscal stability? Is there any evidence that we should increase taxes?

Mr. CRIPPEN. I don't know that there is any evidence for that, Senator. It is a policy choice you all have to make. Let me go back to where I always end, and didn't today, which is that when you and I retire, what we need to worry about is how much of the economy we are consuming as retirees, demanding that our kids give us. And in that kind of outlook, the economists would say, there are only two moving parts: how much we are transferring to retirees (what the benefit level is, if you will, of all the combined programs), and how big the economy is.

So in that view, what you need to be mindful of is perpetuating policies and not to the exclusion of other objectives, necessarily, but perpetuating policies that help economic growth. Most economists would say tax increases wouldn't help economic growth most times. So that would suggest you wouldn't want to raise taxes.

But you may have other objectives in addition to economic growth. All I am suggesting is you need to keep your eye on that one when you are looking at long-term issues, particularly the retirement of our generation.

Senator FRIST. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Feingold.

Senator FEINGOLD. Thank you, Mr. Chairman. And thank you, Director Crippen, for appearing before the committee. I look forward to reviewing the CBO analysis I more detail, and I, of course, having looked at this for a few years, appreciate the differences between the OMB estimates and assumptions and those of the CBO. And I understand that that might not be terribly interesting to a lot of observers. It is not easy to present that difference in a compelling way. But to those who would dismiss the differences, I remind them that in late 1995, the leadership in the other body actually shut down the Government over these differences, so they are not inconsequential.

We have not really had a chance to go over the CBO analysis of the President's budget, but though there may be differences in some estimates and underlying assumptions, the big picture appears to be the same. The President's budget will not be balanced this year, nor will it be in balance for the foreseeable future without using the Social Security Trust Fund reserves. And I find this, as I am sure many people do, particularly frustrating given the latest report that CBO's new estimates of the baseline actually project a small unified surplus for the coming year, as you reported.

Mr. Chairman, as you have pointed out time and again, we are on the brink of a huge challenge. You quoted Dr. Crippen with his very clear and strong remarks earlier this year about the retirement of the baby-boom generation and with it the very significant pressure on Social Security and Medicare.

A year ago, we were reasonably well positioned to address that challenge, even with the economic slowdown that ensue. That is no longer the case. Thanks to the tax cut and the spending policies enacted last year, now we are actually facing what is sort of a steep uphill climb.

The President's budget makes that climb even harder. The load we will carry has been made much heavier with still more tax cuts, and then also a record increase in defense spending.

Mr. Chairman, no one questions the need to provide adequate funds to fight the warm on terrorism, but we will not be effective in that fight by adopting what one commentator has characterized as a "leave no defense contractor behind" defense budget.

Fully funding three new tactical fighter programs did not make sense a year ago, and it doesn't make sense now. We absolutely have to get serious about deficit reduction. Mr. Chairman, no one holds this cause more dear to his heart than you do. We shouldn't wait. We should start right now. We should balance the unified budget this year, and then commit to a glide path to balance the budget without using the Social Security Trust Fund, balance this by 2007 at the latest.

With the CBO report today, I think it is clear that it is possible. Indeed, apparently the baseline unified budget will now be in balance in fiscal year 2003.

Mr. Chairman, I think we should balance the books using the assumptions and the estimates of the Congressional Budget Office, not OMB. This may be an obvious point, but I think it is necessary to mention it because I have heard now, ironically, that there may be a move by the other body to use OMB estimates if in doing so it somehow makes it easier to craft a budget.

This would be, to say the least, as I said, ironic, given the position that the House took 6 years ago when they shut down the Government over this issue. And it may be a moot point. It may be that using OMB numbers will not provide a significant advantage for budget writers, but if they do, I don't think we do the taxpayers any favors by building a budget on the very rosiest scenarios we can find.

I find it troubling that we almost half to resume this mantra again. Every politician in the 1990's said it in every campaign. We are back to it. We have to start beating the drum again, and that is that we won't be doing our children and grandchildren any favors by running up deficits now and letting them pick up the tab. I thought we were going to have a few years here we wouldn't have to be saying that, but it looks like we have to say it now with even greater intensity so we can get back on a glide path to have a balanced budget.

Dr. Crippen, the short-term estimates look a little better than we thought a few weeks ago, as you have indicated, but it appears that the long-term challenges that you have discussed before are still facing us. Could you say a little bit more about the trend line of the President's budget or the baseline, for that matter, as it extends into the next decade when the baby-boom generation starts to retire?

Mr. CRIPPEN. As I have said to the distress of some—and repeated to the distress of everyone, I guess—we now have 39 million Medicare and Social Security recipients, and that will be 80 million by the time our generation is through working. That alone has to give you pause. But when you look at what resources are going to be devoted just to those Federal programs for retirees, it more than doubles over this time period. That is not to say that you couldn't or wouldn't want to raise taxes or increase borrowing at that point to finance some of the benefits. But you probably can't do any of those things for all of the benefits. It just will be the largest single fiscal policy change, I think, this country has ever seen to have those kind of changes either in the rest of Government as we know it or in the financing of Government as we know it.

It would probably be unsustainable (though no one knows for sure) to borrow our way out of it at that point. So the question is, do we want to tax our children at those high rates, take either 30 percent or 25 percent of what they produce at that time to finance those benefits?

Those are the questions that we all will need to face, and this 10 years we are now looking at is not even a proverbial tip of the iceberg, because our generation will just begin retiring at the end of that period. It is the following 10 or 20 years in which that development will become overwhelming in your budget considerations.

Senator FEINGOLD. Thank you, Doctor.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Domenici.

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

Let me say, Senator Feingold, I always have appreciated your sense of fiscal responsibility, and I listened carefully to what you said. I think the interesting point is that each one of us can develop a theme and also a proposal that fits our desires, but I would challenge you and anyone else on this Budget Committee on either side to put together a budget that is built on the goals as you have stated here today with reference to on-budget and off-budget balances and by what date and the like.

The problem is that all of us look at this fiscal situation, and because of Social Security and Medicare in the out-years, we would like very much to have the fiscal policy you have described. We have dealt some cards that make it pretty tough. That is kind of what I am saying. I am not sure your chairman can do that in the exact way that you have described over multiple years.

Nonetheless, compared to other times, during my 20-plus years serving on this committee, the fiscal policy and what can we look forward to, things are hugely better with reference to deficits and surpluses than they were for most of the 20-plus years that I chaired this committee or was ranking member. As a matter of fact, we used to almost open every session with the concern that the deficit is out there as far as the eye can see, and that——

Senator FEINGOLD. I even remember some of it.

Senator DOMENICI. You were here for some of it. And then we had a very, very excellent and rather exciting year. The problem is it only lasted a little while. That is when we paid down the deficit over a period of 3 years, almost $600 billion, which is something rather dramatic. It is more than a down payment. It is a very significant event in the fiscal policy of this great Nation.

Then things happened that we couldn't do it, and everyone has something to blame for it. I am not now accusing you of that. Everybody suggests they know why we are no longer able to pay that surplus—to use surpluses to pay down deficits because surpluses aren't there.

I am firmly convinced that it is not the tax cuts that harm our situation. I am more concerned than I ever was about sustaining the growth in this economy for the next 7, 8, 9, 10 years. Just imagine if we see another 7 to 8 years like the ones we saw just before we were able to start paying down this huge deficit. If that happened again in the next decade or 15 years, that would again be a rather incredible situation. And I think that will not occur just because we balance the budget 1 year versus another or because we don't touch Social Security Trust Funds or we do.

I think what is going to happen is we are going to get a huge spate of economic growth because we do things as right as we know how for economic growth.

I think we have latitude, fiscally speaking. The problem is the latitude doesn't have with it political plus for each of the various proposals that one could come up with, because we have convinced ourselves that we cannot write a budget—some have—unless, as a matter of fact, it is balanced and unless it shows that we are not using any of the surpluses that come from Social Security and Medicare.

That would make it difficult for this chairman, for this committee, for all of us. In the meantime, we have a war, costing us $1 billion or so a month, and we are just coming out of a recession, which we should heed and say we would like to come out of it as robust as we can and for as long and as strong as we can.

Based on that, I have just a couple of questions, and they will be very brief.

On your revised economic forecast on Table 4, page 20, you state that you now forecast GDP growth of 1.7 in 2002, up from January estimate of 0.8. And yet as we look at your testimony and report, we see no change in your January estimate for inflation measured by CPI. It stays at 1.8. No change in unemployment rate forecast from last January. It stays at 6.1. And no change in the 10-year Treasury note rate forecast from last January. It stays at 5 percent.

I guess we in reviewing this would have thought that with more than doubling your forecast for GDP growth this year from January that these other economic variables would have been affected, maybe higher inflation, lower unemployment, something like that. Could you talk with us about that, please?

Mr. CRIPPEN. Sure. First, we don't know exactly why the fourth quarter was as positive as it was. That is, it looks like wages and salaries are about where they were in our January forecast, so we can't infer greatly different unemployment in that sense. Therefore, it looks like it is corporate profits that have gone up, and, that is where we made our change.

But it is not clear what effect this relatively small change, would have on all of those other variables.

Second, even if we had thought there were impacts, we didn't have time to make a full change in our economic forecast. As you know, Senator, we began this process back in November and formalized the forecast in December, and it takes a number of weeks to actually incorporate all of that into our baseline report that we do in January. So we frankly didn't have enough time in the last couple of weeks to do a complete reforecast, anyway.

We see here that it looks like productivity is still holding up quite well, over 2 percent maybe in this last quarter, higher than we would have expected in a recession. At times, in the beginning of a recession, productivity tends to drop because employers retain employees in anticipation of business picking up later on. That didn't happen here. There had been some discussions in the popular press about the role of temporary workers and others and how all this adjustment takes place.

That is a long way to say, one, we are not sure exactly what has transpired in the fourth quarter . Some of it is inference we are making, but clearly, we wanted to at least take note of the positive reports for the committee and incorporate them to the extent we could. And two, we didn't have time to make a complete revision of the forecast.

Senator DOMENICI. But it is true that the numbers in the outyears would change with lower unemployment and slightly lower inflation.

Mr. CRIPPEN. They could in the next year or two, though in the long run it still depends critically upon the long-run trend for productivity and growth in the work force. And we haven't seen anything yet that would make us change that forecast from last January.

Senator DOMENICI. I am sure that we are going to hear as a result of your testimony today that the President's budget has cut non-defense discretionary spending over $188 billion over the next decade, and that number appears on the first page of your testimony. And let's see if we have this correct. This is a reduction from a baseline that the Budget Act mandates you produce and that mandates that the total discretionary spending be constructed by taking the last appropriation act in Congress, including one-time emergency supplementals, and taking that number and inflating it all the way into the future. So the $20 billion in fiscal year 2002 emergency appropriation, following the September 11th attacks, is included in your baseline inflated all the way out to 2012. Is that correct?

Mr. CRIPPEN. That is correct, Senator.

Senator DOMENICI. And if the staff that has prepared me on this are correct, that accounts for over $200 billion in discretionary spending in your baseline.

Mr. CRIPPEN. That is correct.

Senator DOMENICI. About $40 billion for defense and $160 billion for non-defense.

Mr. CRIPPEN. That would be correct.

Senator DOMENICI. So this cut supposedly proposed by the President in non-defense discretionary spending is not really 188, but, in fact, is an increase in non-defense discretionary spending in 2003 by about $3 billion, and indeed a cut over the decade, but more like $30 billion, not $188 billion. Is that correct?

Mr. CRIPPEN. That would be correct from your numbers, yes.

Senator DOMENICI. I thank you very much. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Director Crippen, I would like to direct your attention back to page 18 and the question of how big the deficits are if Social Security is not counted.

Mr. CRIPPEN. Right.

Chairman CONRAD. In 2003, as I read your table, the deficit, not counting Social Security, would be $297 billion if the President's budget proposals were adopted. Is that correct?

Mr. CRIPPEN. Right.

Chairman CONRAD. The next year the deficit, not counting Social Security, would be $245 billion.

Mr. CRIPPEN. Right.

Chairman CONRAD. And the next year, $187 billion. And going right out through the entire 10-year period, there is never less than $100 billion of deficit if Social Security is not counted. Is that correct?

Mr. CRIPPEN. Correct.

Chairman CONRAD. And, in fact, over the entire 10-year period, the total deficits, not counting Social Security, are $1.8 trillion. Is that correct?

Mr. CRIPPEN. Correct.

Chairman CONRAD. Let me just repeat that. If Social Security surplus funds are not included in the calculation, during the entire 10-year period the cumulative deficits are $1.8 trillion. That is correct?

Mr. CRIPPEN. Correct, yes.

Chairman CONRAD. How big was the tax cut over the 10-year period that was passed last year?

Mr. CRIPPEN. I am going to have to rely on my colleagues. $1.3 trillion.

Chairman CONRAD. Yes, and how much would the debt service cost of that be as well?

Mr. CRIPPEN. As I recall, over $300 billion, so it rounded up to $1.7 trillion for the total impact on the budget.

Chairman CONRAD. Total impact on the budget over the 10 years of the tax cut is $1.7 trillion, and the cumulative deficits, not counting Social Security, are $1.8 trillion. My ranking member said he doesn't see any connection between the two. I think there is a direct connection. The amount of the tax cuts the President pushed, proposed, pushed through Congress last year, is almost directly equal to the cumulative deficits over the 10-year period if Social Security funds are not included in the calculation.

Now, there has been a lot of talk about whether the tax cuts contributed to a shorter deficit. I certainly hope so because on both sides here we supported tax cuts last year, substantial tax cuts last year, to give lift to the economy. Isn't that the case?

Mr. CRIPPEN. Yes.

Chairman CONRAD. And we did so on the basis that tax cuts at a time of economic slowdown would give lift to the economy, would increase consumer demand. Isn't that the theory?

Mr. CRIPPEN. That is the theory.

Chairman CONRAD. And, in addition to that, we increased spending in response to the attacks on this country, and increased spending would also give lift to the economy at a time of economic slowdown. Isn't that the case?

Mr. CRIPPEN. It is generally thought to be, yes, depending on what you spend it on.

Chairman CONRAD. And so the one thing we agreed on last year is that we needed to do both those things. We needed to give tax cuts in the short term and we needed to have increased spending to respond to the sneak attack on this country, and that combination would give lift to the economy.

At the same time, many of us—I certainly argued that the magnitude of the tax cuts over the 10 years were too high and would threaten the Social Security Trust Funds. Some mocked me for that, said, no, these surpluses are so large that we can have a tax cut of this magnitude and not endanger the trust funds. That argument was made repeatedly. In fact, I had members on this committee tell me you are worried unnecessarily. These surpluses are too small. I was told that repeatedly, that there was even going to be more money than was forecast.

We didn't get more money. We got a lot less money. The result is we have got a tax cut that was put in place over the 10 years—that is the argument I have—over the 10 years that is almost equal to the non-trust fund deficits we have over the next 10 years.

That means to me surpluses in the trust fund accounts are being used to pay for the tax cut and other spending. It is just as clear as it can be. The consequences of that are serious because the baby boomers start to retire in 6 years. And we know the whole thing doesn't add up.

And I want to make clear, I don't believe saving Social Security and Medicare Trust Funds solves the problem. I don't want to mislead anybody on that account. That is why the budget proposal I made last year not only saved those funds for the purposes intended, but also transferred money from the general fund, $900 billion to deal with these long-term liabilities, to in effect prepay some of that liability.

Director Crippen, have you analyzed what other countries are doing who face the kind of demographic change we are facing? Have you looked at any other countries who have got the same demographic profile that we do?

Mr. CRIPPEN. Not in a thorough way that I would be able to report on. I think the truth is that in many countries—and Japan, of course, comes to mind first—the outlook at the moment is even worse, for two reasons: first, they will have more of an elderly overhang, fewer workers supporting elderly, in part because they live longer; and second, without economic growth, which hopefully they are now just beginning to experience again, they won't have the kinds of resources we hope our country will have when the time comes.

But that is an anecdotal, not a complete, look. We have not looked at other countries thoroughly.

Chairman CONRAD. I wonder if you would be willing to assign some people, if we were to make a formal request to you, that is, this committee, to look at a number of other countries that have the demographic profile we do and look at how they are addressing these long-term fiscal imbalances. You would agree, I take it—and I don't want to put words in your mouth, but would you agree that we face long-term fiscal imbalances that are serious and require our attention?

Mr. CRIPPEN. Yes, absolutely.

Chairman CONRAD. And how serious would you characterize those long-term fiscal imbalances as being?

Mr. CRIPPEN. Well, I have fairly consistently said that the changes, no matter what they are, that we need to make are going to be unprecedented, and that they will occur in a very short period of time, and that our budget will look different and the financing of it very different than it ever has.

So the changes are going to be quite stark. It is not a matter of saying that there is necessarily a pending crisis, certainly not to say that anybody currently on Social Security and Medicare needs to be concerned in the short run. But ultimately we are going to have to change our fiscal policy to accommodate the obligations, or at least the promises, we have made to our generation.

Chairman CONRAD. Is it true, in your judgment, that although all the payroll taxes are credited to the trust funds, credited to the Social Security Trust Fund, even though that is certainly the case, and there are assets in the Social Security Trust Fund, that is, Government bonds that are bearing interest, backed by the full faith and credit of the United States, that still a future Congress and a future President will face very difficult choices because those labilities will have to be redeemed out of the income, the future revenue of the Federal Government at a time those liabilities come due?

Mr. CRIPPEN. That is absolutely correct, Mr. Chairman. In 2011, or thereabouts, when the actuaries think that payroll taxes will be insufficient to cover benefits for Social Security, at that point the Social Security Administration will go to the Treasury with interest demands on the debt that is in there, and Treasury will then have to produce cash to pay those interest payments in order for the checks to be cashed. And in doing so, the government has only the usual three choices: raising taxes, increasing borrowing from the public, or cutting spending somewhere else.

And that is true whether or not there are trust funds and whether or not there are assets. So come 2011, what is going to happen in the fiscal situation of the country is identical with or without trust funds at that point. What is important is what happens between now and 2011 to make it easier to pay off those obligations, whether they are debt held by the trust funds or whether they are obligations, moral or otherwise, to sustain the elderly in these programs.

Chairman CONRAD. You are saying that the trust fund of Social Security goes cash negative in 2011?

Mr. CRIPPEN. I believe that is the right year.

No, actually we think it may be 2016.

Chairman CONRAD. 2016 is the year that we have been using, and I just wanted to check to make sure we are on the same wavelength. They go cash negative in 2016. The thing that is important about that, it seems to me—and I would be interested in your take on it—right now the trust fund of Social Security is throwing off substantial surpluses. Is that not the case?

Mr. CRIPPEN. Yes.

Chairman CONRAD. That is going to change when we hit 2016.

Mr. CRIPPEN. Correct.

Chairman CONRAD. What is allowing us as a Nation to foot these bills? That is, if you don't count Social Security, we have just gone through the numbers. We will be spending over the next decade $1.8 trillion more than is coming in. Isn't that the case if we are not counting Social Security?

Mr. CRIPPEN. Without the excess payroll taxes, yes.

Chairman CONRAD. Without the Social Security surpluses, they aren't counted and part of the calculation, we will run $1.8 trillion of deficits over the next decade. That is the run-up to the time that you have indicated the trust fund will start going cash negative. Then all of this changes, doesn't it?

Mr. CRIPPEN. Yes, Senator, in the sense that the obligations that we have to retirees at that point will not be fully funded by the tax system currently in place.

Chairman CONRAD. So what would that mean? In order to keep the promises made on benefits, you would have to have a dramatic tax increase, wouldn't you?

Mr. CRIPPEN. Tax increase, borrowing increase, or cut in other Government spending.

Chairman CONRAD. And we will be talking by large amounts, large tax increases, large increases in borrowing, large cuts in other programs. Isn't that the case?

Mr. CRIPPEN. Yes.

Chairman CONRAD. The Comptroller General testified that as they look ahead, under any of their scenarios, we are headed for at different time periods—they have three major scenarios. As they look ahead, they have different periods at which the situation becomes most dire, but under any of the three, the Comptroller General indicated we are headed for, with current law, with the tax cuts extended, that we are headed for deficits as a percentage of gross domestic product of 20 percent. Twenty percent of gross domestic product as a deficit. If we had deficits today of 20 percent of GDP, that would be a $2 trillion deficit, would it not?

Mr. CRIPPEN. Right.

Chairman CONRAD. How big is the total Federal budget?

Mr. CRIPPEN. $2 trillion.

Chairman CONRAD. $2 trillion.

Mr. CRIPPEN. Yes.

Chairman CONRAD. So if we had deficits of the magnitude that the Comptroller General of the United States is forecasting in our future because of these demographic changes, we would face deficits this year that are as big as the entire Federal budget. Isn't that the case?

Mr. CRIPPEN. Roughly. Think about it this way (at least, I find it a little easier) we are currently spending 18 to 19 percent of GDP for all Federal programs. The President's budget would have spending, I believe, at about 19.5 percent for next year. If our projections are anywhere in the ballpark, we will be spending 15 or 16 percent of GDP on Federal health retirement programs alone. So the——

Chairman CONRAD. When would that be?

Mr. CRIPPEN. By that point, it would be 2030, but the ramp-up is pretty significant, of course, between 2010 and 2030. So all of that is to say everything the Federal Government does today from defense on down spends about 19 percent of the economy. That is what it takes to fund it. Sixteen percent will be required to fund programs for the elderly in 2030. So the difference obviously is roughly 3 percent of GDP for everything else.

Chairman CONRAD. And that would only cover, as the Comptroller General told us, interest on the debt.

Mr. CRIPPEN. That could well be. So the point is——

Chairman CONRAD. Right about everyone else, there would be no money for Medicare, there would be no money for Medicaid, there would be no money for defense.

Mr. CRIPPEN. Medicare and Medicaid were included in our 15 to 16 percent number, but everything else—the rest of the Government as we know it—will obviously be squeezed into the 3 percent, if you didn't borrow or you didn't raise taxes.

Chairman CONRAD. His numbers are—he is coming at it a somewhat different way. He says at the most difficult point when the baby boomers are fully retired, there will only be money for Social Security and interest on the debt. There would be no money for Medicare, there would be no money for the other functions of Government. That is at the depth—that is his calculation.

You are making much the same point in a somewhat different way. You would have money for the retirement programs and roughly interest on the debt, no money for anything else.

Mr. CRIPPEN. Right.

Chairman CONRAD. I tell you, I hope that people are listening. None of my colleagues are. People are watching on television. I have already had colleagues call me and tell me they were watching this.

You know, this is reality, and I think people are having a hard time kind of adjusting to where we are headed simply because it is unlike anything we have seen before. Would you agree with that?

Mr. CRIPPEN. Absolutely.

Chairman CONRAD. What we are faced with in the future is just unlike anything we have seen before. And those who keep talking—and I have got discussions going on with colleagues all the time in which they say, you know, Senator Conrad, why are you so worried about what is to come? We have been getting through—we have gotten through the last 200 years without that much trouble, and what is the big problem?

The big problem is what we are about to experience is unlike anything we have ever experienced before. Would you agree with that characterization?

Mr. CRIPPEN. Yes. I would say, and probably should have sooner as well, that our children, who are going to be faced with providing for us in our retirement, no matter how you think about it, will also be better off than we are because of real economic growth between now and then. But as you said, there will only be two of them for each of us. And the proportion of total income that goes to the government as taxes will be 30 percent, although it may be 30 percent of a bigger pie.

So it is not absolutely true that we will be unable to raise taxes or other financing to cover the costs. We don't know. But it certainly suggests, as you have said, a very large change in our fiscal outlook and fiscal policy and how we finance these benefits.

So it may be—and maybe some of your colleagues think it will be—relatively easy to go to 30 percent of GDP for taxation. I don't know. That is certainly not the situation the country has seen. Revenues have averaged about 18 percent of GDP since World War II, and the peaks have been around 20 percent. In——

Chairman CONRAD. Out of the—I am sorry to interrupt.

Mr. CRIPPEN. No, that is all right.

Chairman CONRAD. That would be—30 percent of GDP going to taxes would be a 50 percent increase over anything we have experienced before.

Mr. CRIPPEN. Yes.

Chairman CONRAD. Well, it strikes me as highly unlikely, and I even question whether that would be desirable because that would have an impact on economic growth, would it not?

Mr. CRIPPEN. For our grandchildren, yes, absolutely.

Chairman CONRAD. All right. I thank you, Director Crippen. I want to conclude as I began by thanking you and your very able staff for making special efforts to get us these re-estimates on a timely basis for the work of the committee given our truncated schedule this year, our compressed schedule, if you will. And, again, if you would tell you staff how much we appreciate the work that has been done.

Mr. CRIPPEN. Absolutely. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

[Whereupon, at 11:35 a.m., the committee was adjourned.]

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