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S. HRG. 110–162. Vol. I

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2008

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

January 11, 2007—THE LONG-TERM BUDGET OUTLOOK

January 18, 2007—THE LONG-TERM ECONOMIC AND BUDGET CHALLENGES

January 23, 2007—THE GROWING TAX GAP AND STRATEGIES FOR REDUCING IT

January 25, 2007—THE CBO BUDGET AND ECONOMIC OUTLOOK

January 30, 2007—DEFINING OUR LONG-TERM FISCAL CHALLENGES

January 31, 2007—EXPLORING SOLUTIONS TO OUR LONG-TERM FISCAL CHALLENGES

Volume I of II

Printed for the use of the Committee on the Budget

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VOLUME I

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HEARING ON: LONG-TERM BUDGET OUTLOOK

THURSDAY, JANUARY 11, 2007

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

The committee met, pursuant to notice, at 10:34 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Domenici, Grassley, Allard, Graham, Conrad, Murray, Cardin, Sanders, and Whitehouse.

Staff present: Scott Gudes, Majority Staff Director and Mary Naylor, Staff Director for the Minority.

Chairman GREGG. Let me call this hearing to order, which is—I am sure some people are saying, what is he doing that for, he is not in charge any more? They are saying, what is he doing that for?

Due to the vagaries of the Senate's arcane rules, I technically am still chairman, I guess. But that is obviously a technical point. I look forward to working with Chairman Conrad. We have had a very good, strong relationship. I very much appreciate his and his staff's extraordinarily cooperative and positive approach during my tenure as chairman. I intend, and our staff intends, to take the exact same approach and really use his example as our template as to how we will proceed.

So at this time I will yield to Senator Conrad as chairman and relinquish my chairmanship, even if it is only technical.

OPENING STATEMENT OF SENATOR KENT CONRAD

Senator CONRAD [presiding]. I thank my colleague. I thank Senator Gregg very much for the way he has conducted this committee. Senator Gregg has been an exemplary chairman. He has conducted this committee professionally and with good humor and with fairness. He gives us all a good example of how committees should be chaired in the U.S. Senate.

He has also graced this committee with outstanding staff. We have had just a very good, very positive working relationship on this committee and we intend to continue it.

Senator Gregg and I have had lengthy discussions about the enormous fiscal challenges facing the country and our desire that we enter into a process to be able to address those issues and to do it this year. Obviously, whether or not that goes forward is at a higher pay grade than ours. It involves the President of the United States. It involves the leadership of both the House and the Senate. But I think it is fair to say that we are prepared to work in good faith to try to find solutions to these vexing long-term issues that, I believe, fundamentally threaten the long-term economic security of the country if they are not addressed.

Senator Gregg has repeatedly demonstrated that he is serious about this. So I very much look forward to the opportunity to work with him and others of our colleagues to try to address these issues.

I also want to take this moment to thank and welcome the new members of this committee. I see Senator Whitehouse is here. We are delighted to have you.

Sheldon, let me just say to you that when I started on this committee that is where I was.

Chairman GREGG. No, you were behind the screen.

Senator CONRAD. I was behind the screen.

I also want to welcome Senator Ben Cardin of Maryland, who served on the Ways and Means Committee and is deeply knowledgeable. We are delighted to have him as a member. Senator Sanders of Vermont as well.

I also should indicate that Senator Lautenberg, the former distinguished ranking member of this committee, has agreed to temporarily serve in Senator Johnson's spot pending Senator Johnson's recovery.

Let me say that all of our colleagues are hoping and praying for Senator Johnson's full and swift recovery. We have been delighted by the reports of recent days of Senator Johnson's progress and we eagerly await his return. But we so thank Senator Lautenberg for his willingness, as a former ranking member of this committee, to come back to temporarily serve in Senator Johnson's slot.

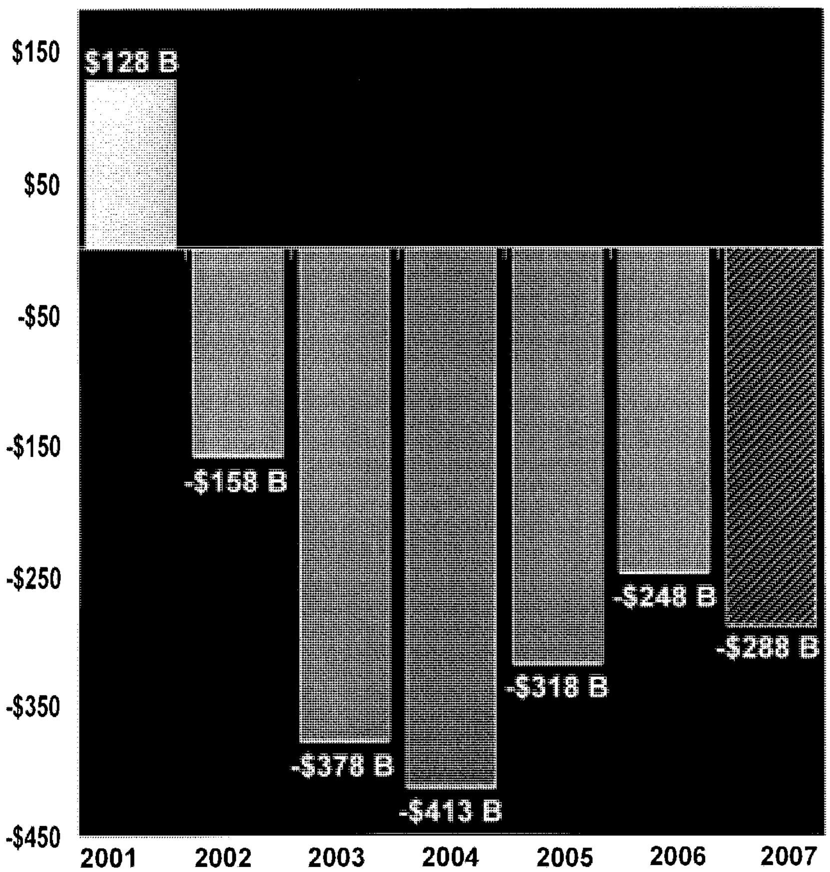
With that, I want to commend you, Mr. Walker. You are the head of the General Accounting Office. You could sit in your office and issue reports and nobody could fault you for that. But really these circumstances demand more and you are giving more. I want to publicly thank you. We do not have to agree on every single thing, every statement you have made. I have had a number of members of the press closely quizzing me in the last 24 hours, do I agree with this Walker statement, that Walker statement. That is not the point. I agree with the overall message that you are attempting to deliver to the Nation they we are on an unsustainable course and it has simply got to be changed.

Before I go further I want to again thank Senator Gregg for his assistance in organizing this hearing, because we could not have proceeded without him as he is still chairman of this committee in a formal sense. Again, I deeply appreciate the way he has cooperated so we could have this hearing.

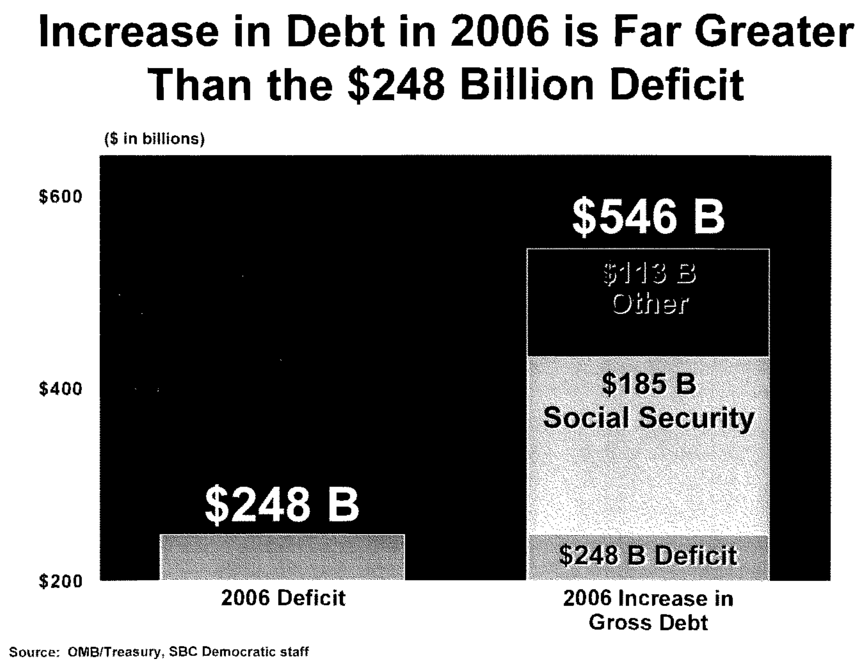
Since 2001, the Nation has undergone a dramatic budget deterioration. We all know the pattern; record deficits. But more importantly, the debt is going up more rapidly than the size of the deficits. This is a point that I think is too often lost. Last year the deficit was $248 billion, but the debt increased by $546 billion. I think this is a point that has too often been lost.

Dramatic Deterioration in Budget Picture

(Deficit in billions of $)



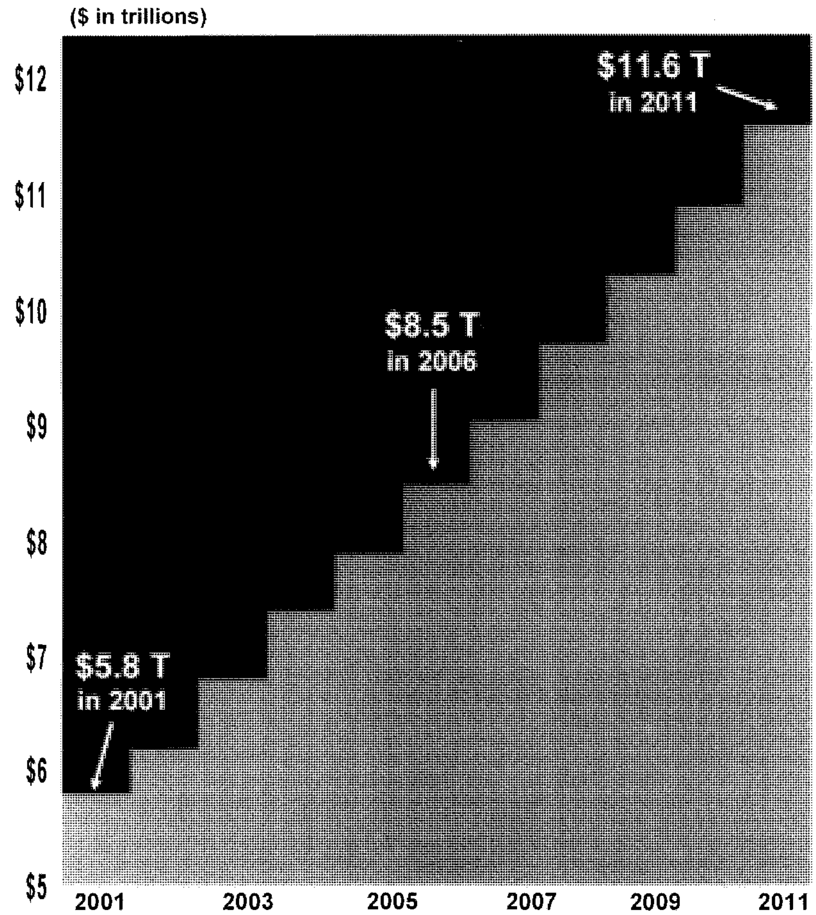
Source: CBO, OMB/Treasury, and SBC Democratic staff
Note: For 2007, reflects CBO August 2006 Budget and Economic Outlook, with President's policies as reestimated by CBO in March and CBO's estimate of ongoing war costs and AMT reform.



We are facing a wall of debt. At the end of 2001 the gross debt of the country was $5.82 trillion. At the end of 2006 that had mushroomed to $8.5 trillion. And if we continue on the President's course we will have the debt soar to $11.6 trillion by 2011.

Building a Wall of Debt

Gross Federal Debt Soars



Source: OMB, CBO and SBC Democratic staff
Note: CBO August 2006 Budget and Economic Outlook, with President's policies as reestimated by CBO in March and CBO's estimate of ongoing war costs and AMT reform.

The result is that increasingly we are borrowing these very large amounts of money from abroad. Fifty-two percent of our debt now is financed abroad. We have doubled foreign holdings of U.S. debt in just the last 5 years. We owe enormous sums of money to Japan, to China, to the United Kingdom.

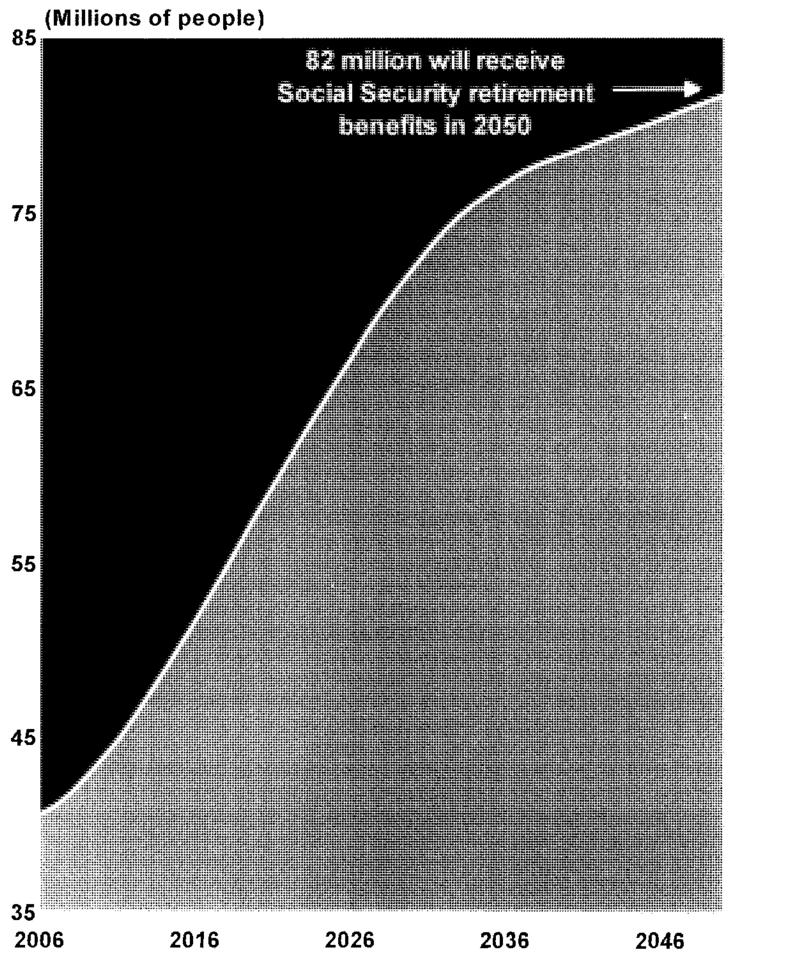
Top Ten Foreign Holders of Our National Debt

Japan	$641 B
China	$345 B
United Kingdom	$208 B
"Oil Exporters"	$98 B
South Korea	$69 B
Taiwan	$64 B
"Caribbean Banking Centers"	$56 B
Germany	$53 B
Hong Kong	$51 B
Canada	$50 B

Source: Department of Treasury
Note: As of October 2006

This increase in debt is happening at the worst possible time, right on the brink of the retirement of the baby boom generation, a point that you, General Walker, have made repeatedly, that right now is in many ways the budget sweet spot. We have coming at us something we have not seen before and perhaps it is one reason our colleagues have a difficult time adjusting to it. It is this demographic tsunami of the baby boom generation and it is going to change everything, and that is not a projection. These people have been born. They are alive today. They are going to retire and they are going to be eligible for Social Security and Medicare, and we have to get ready.

Number of Social Security Beneficiaries Explodes with Retirement of Baby Boom Generation

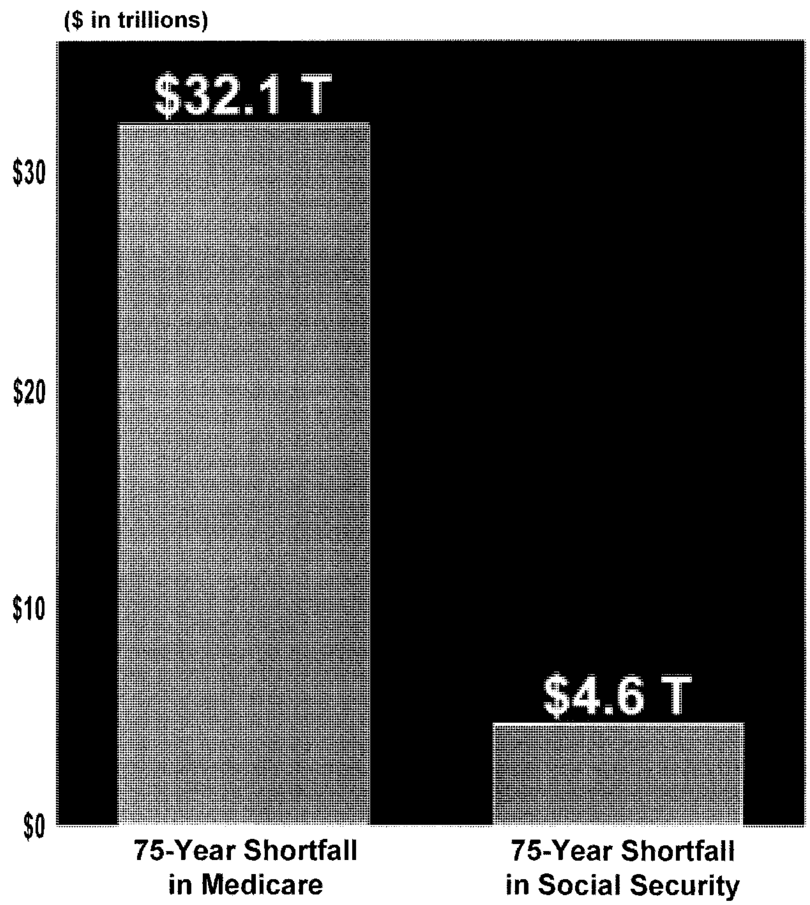


Source: 2006 Social Security Trustees Report
Note: OASI beneficiaries

The number of Social Security beneficiaries is projected to climb to 82 million people by 2050. But we need to remember that Social Security is not the biggest budget challenge. Because of rising health care costs over the next 75 years, the shortfall in Medicare is seven times the projected shortfall in Social Security. And by the way, I believe it is far more likely to come true, that is the shortfall in Medicare, than the shortfall in Social Security.

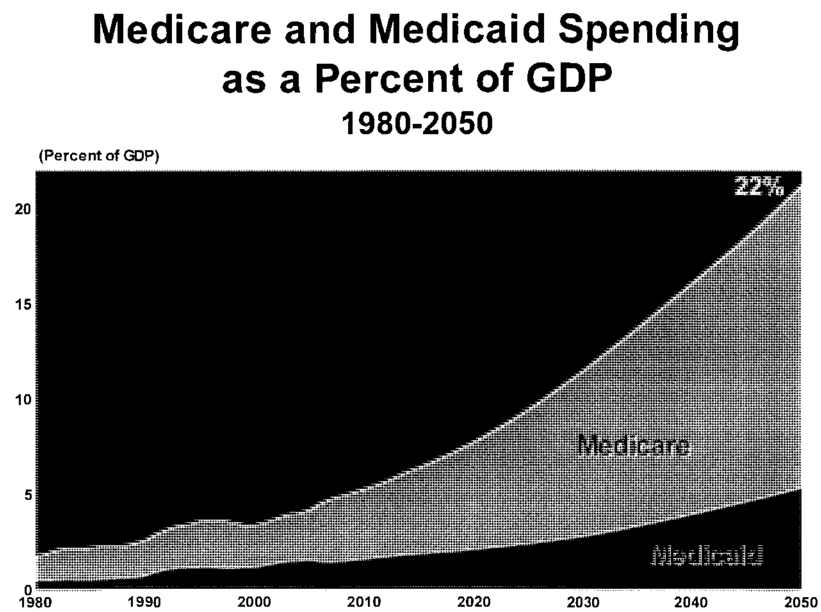
Comparing Long-Term Costs of Medicare and Social Security

Present Value of Costs Over Next 75 Years



Source: Social Security Trustees 2006 Annual Report

The growing cost of Medicare and Medicaid is simply staggering. By 2050, if nothing changes, more than 20 percent of our gross domestic product will be spent on Medicare and Medicaid alone. That is about what all of Government costs us now.



Source: CBO Long-Term Budget Outlook, December 2005. Projections assume excess cost growth of 2.5 percent for Medicare and Medicaid.

We do not just have an entitlement spending problem. We also have, I believe, a revenue problem. If all of the President's tax cuts are made permanent, the cost will explode at the very time the cash surpluses in Social Security and Medicare become deficits. In other words, the President's tax cuts will dramatically worsen an already deteriorating budget picture.

Now the good news is these problems are not insurmountable. The fact is, we could make a meaningful difference in these long-term projections if we took action here in the Congress and the President agreed.

I believe it is going to take a bipartisan effort. I believe neither party can do this acting alone. I think we have to work together and act together. It can and must be done, and the American people deserve nothing less.

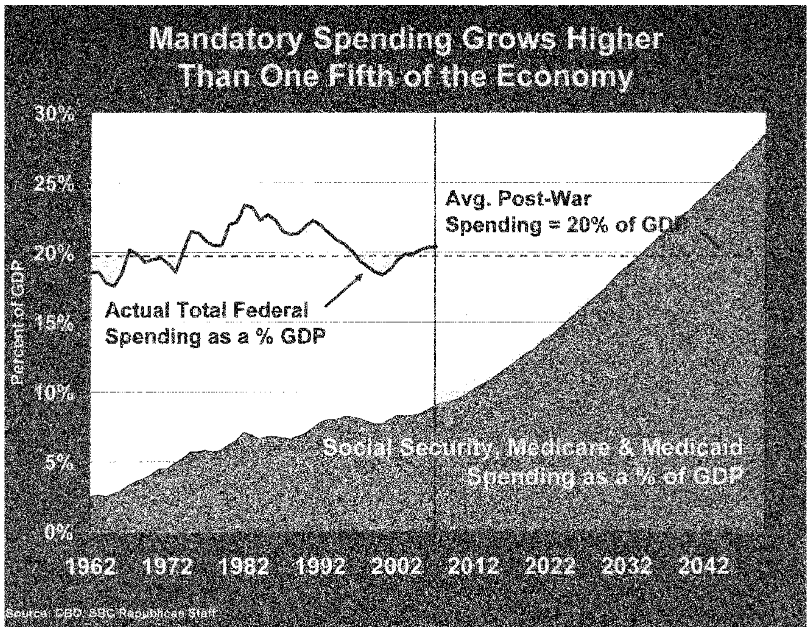
The CHAIRMAN.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. Mr. Chairman. I thank you, Mr. Chairman, and I look forward to working with you, and I want to echo your words relative to cooperation and very much appreciate the professional and constructive way that you worked with us over the years, and we look forward to doing the same. Also I appreciate your starting your tenure with this hearing because it highlights the issue.

I want to thank the Comptroller General for being with us. He has basically been the person who has sounded the alarm most effectively and whose numbers most of us have been using aggressively to carry the message which you have delivered to us. I appreciate your being here today to deliver it again.

To pick up where the chairman left off, this chart, I believe, summarizes the problem in the most concise way.



They are numbers which were referred to by the chairman. Essentially by about the year 2025—three programs, three entitlement programs, Social Security, Medicare and Medicaid, will absorb the historical amount of spending which the Federal Government has done as a percentage of gross domestic product which is 20 percent. In other words, those three programs will cost as much as the Federal Government has historically cost the American people.

So it would mean at that point that you would either have to give up doing everything else the Federal Government does, such as national defense, which is the first priority of a Federal Government, or education or environmental protection. Or alternatively you would have to dramatically start to expand the taxes, because this share consumed by Social Security, Medicare, and Medicaid does not level off at 20 percent, which is the historical norm for all Federal spending. It actually continues to go up. I think the number was cited by the chairman of 27 percent by 2032 of gross domestic product being absorbed. That, as you can see from that chart there, it just keeps going up.

So you have unchecked entitlement spending in the Federal Government as we head out into the next two decades. You can see that it is simply staggering. It is not sustainable. The point has been made that this is not an arbitrary number. This is not one of those projections which is suddenly thrown on the table by looking at tea leaves. The problem exists because the generation that is going to cost us this problem has already been born and is about to retire. We will double the size of the retired generation, the largest retirement generation in history, 80 million people will be retired versus about 35 million today. The level of effort required to support that generation will simply stagger those Americans who are working during this period, and that will be our children and our grandchildren.

The way I have tried to describe it is that we need to pass on a government to our children that is affordable for them and still delivers the quality of services that a retired generation needs. And that means you have to balance this exercise between spending on benefits and revenues.

But you cannot anticipate, you cannot put the whole burden of this exercise on the next generation through raising revenues because you would simply wipe out our children's capacity to have the quality of life we had. We would have to raise their taxes so high that they would be unable to send their kids to college, buy their homes, and live a good lifestyle. So it has to be a balanced approach.

If you were trying to tax your way out of this problem, the tax burden would have would to rise to a level that essentially gives us the same tax burden that some of our neighbors in Europe have, which has led to, in my opinion, the diminution of their lifestyle, their productivity, and their ability to compete with us. So it is simply not an affordable event under the present fact pattern.

Now where the chairman and I depart paths here is how the President's tax cuts affect this exercise. If you look at revenues which we have received under the President's tax cut, we are today receiving more than the historical amount of revenues collected by the Federal Government. This year we are receiving about 18.5 percent of gross domestic product in revenues. Historically, the Federal Government has collected about 18.2 percent of gross domestic product in annual tax revenue. So actually the President's tax cuts are generating revenues that are equal to, essentially, our historical norm.

In fact, we now have a tax law that is even more progressive than the historical tax law. Today, 85 percent of revenues come from the top 20 percent of taxpayers. Under the Clinton years, 82 percent of tax revenues came from the top 20 percent of taxpayers. The bottom 40 percent of taxpayers are getting back about twice today as they used to get back. They do not pay taxes. They are getting about twice as much because of the earned income tax credit as they did under the Clinton years.

So we have a more progressive law. We have a tax law which is generating more revenue than the historical norm. And if we were to repeal this tax law, in my opinion, that would be counterproductive. But if you repeal this tax law, you would see that the revenues would go well above 18.2 percent which is the historical norm. They would end up in the 23, 24, 25 percent range.

We have never had that type of a tax burden put on the American people by the Federal Government. It would stifle productivity, creativity, entrepreneurship and the creation of jobs, and I am not sure that is the way we want to go to solve this problem.

In fact it would not solve the problem because the entitlement growth would still be so staggering that you could not catch it up with tax revenues.

So the issue is huge, and it has to be approached in a balanced way which is that you are going to have to look at the benefit side, you are going to have to look at the revenue side, and you are going to have to face up to the reality that our generation has no right to pass on to our children this problem.

We are the Governors now. We are in charge of this nation. The baby boom generation is responsible for the leadership of this nation. If we pass on this issue, we will have done a total disservice to our children by having passed to them a problem which was our creation and our generation's responsibility to resolve.

So I very much appreciate the Comptroller General being here because most of these numbers are based off of his numbers. We look forward to his characterizing the problem for us again. And then I look forward to working with the chairman to try to come up with some process for actually addressing the problem.

Thank you, Mr. Chairman.

Senator CONRAD. Thank you, Chairman Gregg.

Again I want to thank the Comptroller General for coming back from Ohio early. He was there on the Fiscal Wake-Up Tour. I do not know if that is what it is called but I think that is what it is intended to do. We very much appreciate your coming back early so that you could be our first witness before this committee.

Welcome, General Walker.

STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

General WALKER. Thank you, Chairman Conrad, Chairman Gregg, other members of the Senate Budget Committee. Let me apologize in advance for my voice. I do not feel as bad as a sound, thank God, but I do have a challenge with my voice.

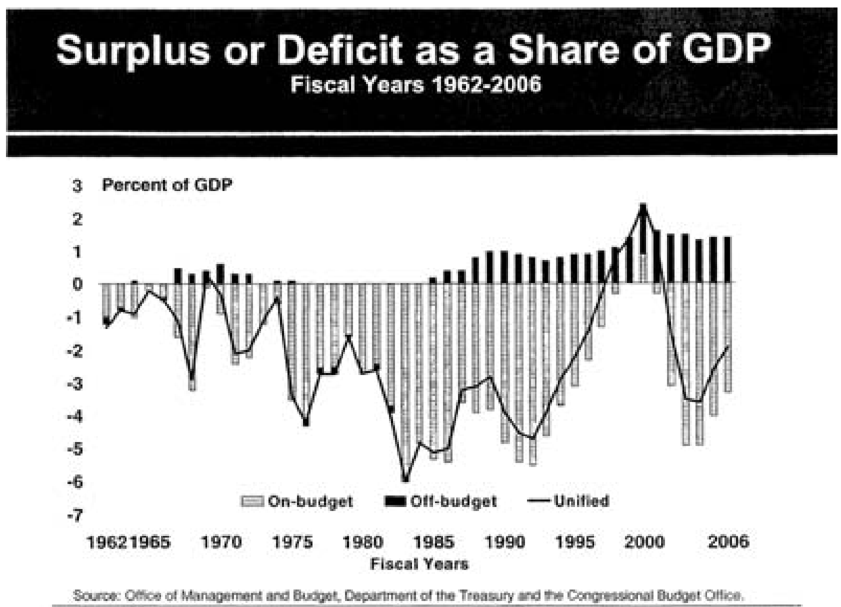
As you pointed out, I have just come back this morning from what was the sixteenth Fiscal Wake-Up Tour outside Washington, DC, which was held in Columbus, Ohio. We had probably 300 to 500 citizens there last night. We had members of the Concord Coalition, fellows from the Brookings Institution and the Heritage Foundation, former Senator John Glenn, OMB director Rob Portman and myself.

Many of the numbers that I will use today were in graphics I used last evening. And let me say that the American people are smart enough to get this. If you state the facts, if you speak the truth, if you help them understand where we have been, where we are, and where we are headed, what the consequences are to our country, our children and our grandchildren, they will enable people to act without losing their jobs.

In fact, what the Fiscal Wake-Up Tour is all about is to try to help till the ground and prepare the way for elected officials, who will ultimately have to make the tough choices, to be able to do so without losing their jobs.

I am going to lay out a picture this morning that is not a pretty one. It is also getting worse with the passage of time. It is fair to say that we have made some progress on our short range deficits in the last few years. And that is good. It is better to have smaller deficits than bigger deficits. But our financial condition is worse than advertised. We are on an imprudent and unsustainable long-term fiscal path. While the short-term deficits have improved in recent years, the long term is getting worse every second, of every minute, of every day, and the time for action is now.

If I can, let me show you a few graphics. I understand that each of you have your own copies of these available if you have difficulty in seeing the screen.



This represents our historical Federal deficits as a percentage of the economy. So inflation is taken out. The red represents the on-budget deficit, excluding the Social Security surplus primarily. The blue represents the off-budget surplus, primarily Social Security. The black line represents the unified deficit; the combination of the two.

You will see that ran larger deficits as a percentage of the economy in the 1980's. But we got something for it. We bankrupted the Soviet Union. We won the cold war. And we declared a peace dividend.

Then in the early 1990's the Congress got serious, imposed a number of budgetary constraints. We had strong economic growth. A variety of things came together and we went from significant deficits to surpluses. We even went to on-budget surpluses. We actually started paying down the debt. People were actually concerned that we may pay off all the Federal debt. Oh my God, would that be terrible. Obviously, I am being facetious here. People actually were concerned about thought that that was going to be a problem. Needless to say, that problem did not come to pass.

We took a big turn in the wrong direction, but as I said before, things have not better in the short term over the last several years. But do not focus on this because this is not the problem.

By the way, there are plenty of people out there that say, do not worry about the deficits. We have had larger deficits as a percentage of the economy. That is like flying a plane or driving a car looking in the rearview mirror. What is important is not where we have been. What is important is where we are heading. And by setting goals to say we want to achieve a certain level in 5 years, while it is good to make progress, that is not adequate. It is like heading to the Grand Canyon at 100 miles an hour and your goal is to slow the car to 50 by the time you get to the edge. Quite frankly, that is not going to get the job done. So our problem is the long term.

Fiscal Year 2005 and 2006
Deficits and Net Operating Costs

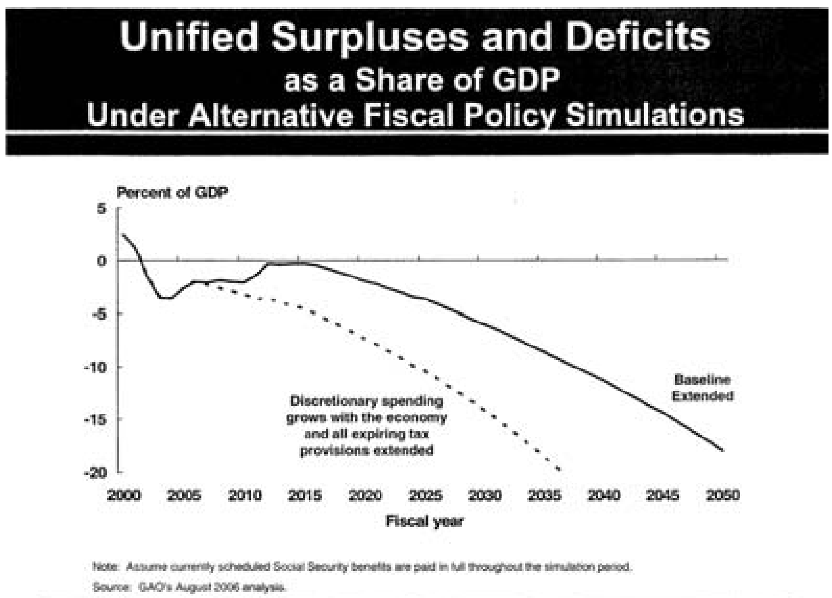
	Fiscal Year 2005	Fiscal Year 2006
	($ Billion)	
On-Budget Deficit	(494)	(434)
Unified Deficit	(318)	(248)
Net Operating Cost	(760)	(450)

Sources: The Office of Management and Budget and the Department of the Treasury.

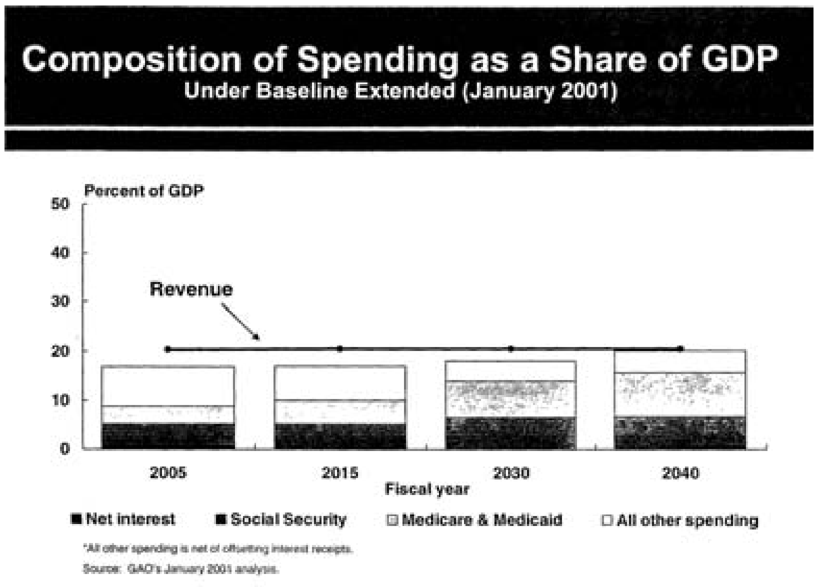
Part of the problem is we have three numbers for the Federal deficit, which in and of itself confuses people. These are not three sets of books, but there are three different numbers for the deficit. And unfortunately, the press tends to only focus on the smallest one. Last year we ran a unified budget deficit of $248 billion. As you know, you have to draw nine zeros to the right of the 248. You do not really appreciate it till you write it out.

But we spent every dime of the Social Security surplus, as we have in most years. So the on-budget deficit was $434 billion. We have not been in a recession since November of 2001. We had among the highest GDP growth rates of any country on earth last year and yet we are running deficits of that size. Most of that deficit did not have anything to do with Iraq and Afghanistan, although they currently do not help. And we had a net operating cost on an accrual basis for financial reporting of $450 billion.

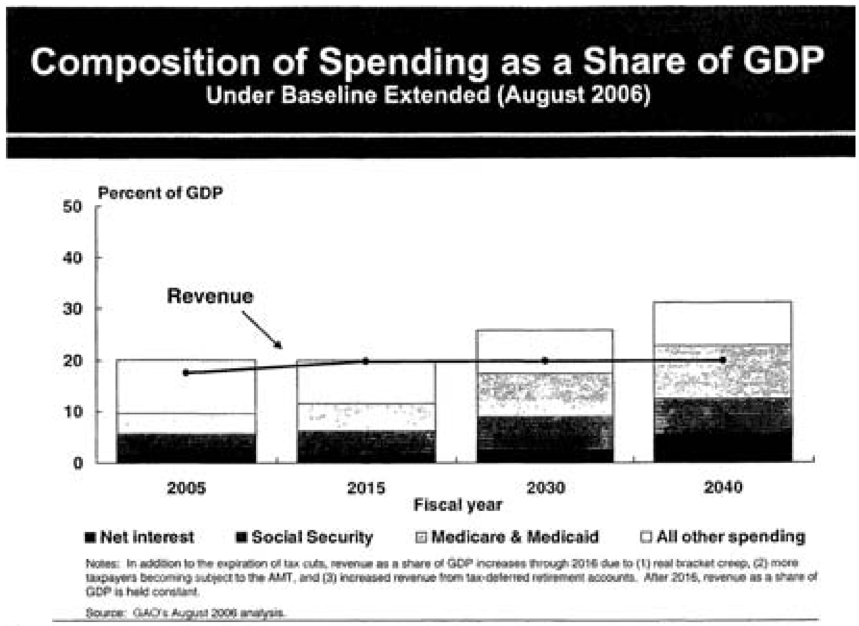
All of these were down from the prior year but they are still imprudently high.



Here is the real problem. As has been shown, whether you go baseline extended or whether you assume that discretionary spending grows with the economy and all tax cuts are extended, the math just does not work. You have already seen this graph. I am going to move on the next one because it is clear.

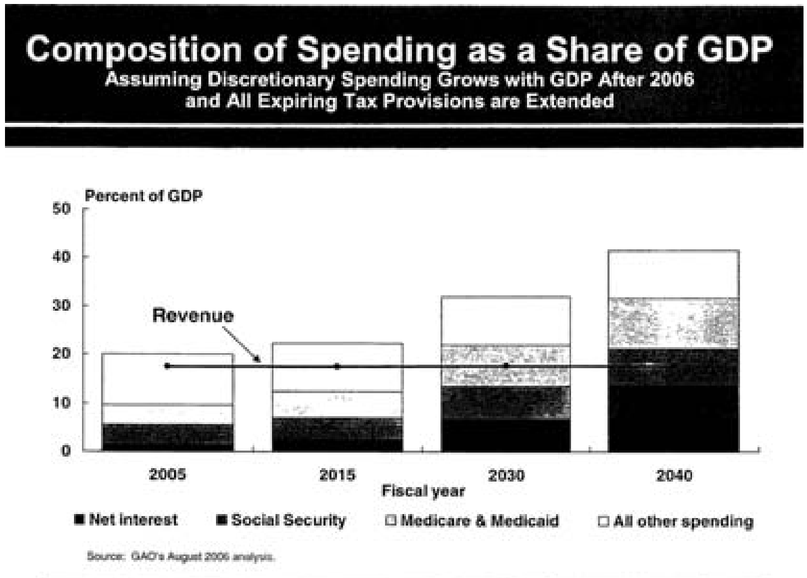


In January of 2001 I testified before the Senate and this was our long-range fiscal simulation in January of 2001. We had fiscal sustainability for 40-plus years in January of 2001. Now this simulation was based upon assumptions, as all simulations are. Some proved valid, some did not. But let me show you where you are today on two scenarios.



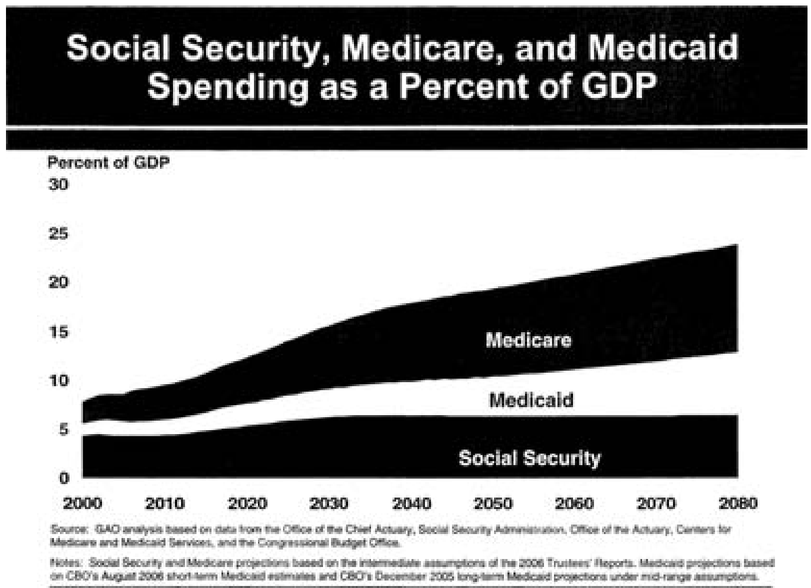
No. 1, this is CBO baseline extended, which assumes that all of the tax cuts expire, which assumes that discretionary spending grows by the rate of inflation for the next 10 years. You can see, even on that basis, we have a long-range problem because if the bar is above the line that is a deficit.

Let me show you the next one.



This one assumes that all tax cuts are extended, something is done about the AMT, and that discretionary spending, which includes national defense, homeland security, judicial system, education, transportation, environment, grows by the rate of the economy.

Under this scenario the fiscal simulation blows up in the 2040's. So we have gone from fiscal sustainability for 40-plus years to the model blowing up in 40-plus years.



As has been shown, this is primarily but not exclusively, due to the explosive growth in Medicare, Medicaid, and Social Security. It is not the only problem. But entitlements are clearly the biggest problem.

Major Reported Fiscal Exposures
($ trillions)

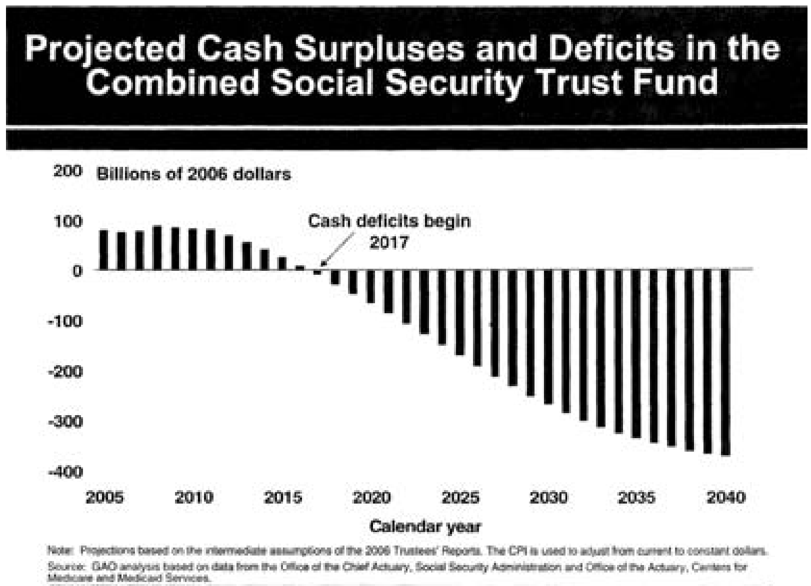
	2000	2006	% Increase
• **Explicit liabilities**	$6.9	$10.4	52
• Publicly held debt • Military & civilian pensions & retiree health • Other			
• **Commitments & contingencies**	0.5	1.3	140
• E.g., PBGC, undelivered orders			
• **Implicit exposures**	13.0	38.8	197
• Future Social Security benefits	3.8	6.4	[illegible]
• Future Medicare Part A benefits	2.7	11.3	[illegible]
• Future Medicare Part B benefits	6.5	13.1	[illegible]
• Future Medicare Part D benefits		7.9	
Total	$20.4	$50.5	147

Source: 2000 and 2006 Financial Report of the United States Government.
Note: Estimates for Social Security and Medicare are at present value as of January 1 of each year and all other data are as of September 30. Totals and percent increases may not add due to rounding.

Now these are in trillions, tens of trillions. So you would have to write 12 zeros to the right of these numbers if they were rounded to the tens of trillions.

In 2000, the United States had major reported liabilities social insurance commitments, and unfunded promises in current dollar terms for Social Security, Medicare and other major items totaled about $20 trillion. Last year that total had risen to $50 trillion—in 6 years, a 147 percent increase primarily due to Medicare.

Medicare prescription drugs did not exist in 2000. It is about an $8 trillion obligation. Medicare prescription drugs alone added more unfunded commitments to the U.S. Government than all of Social Security. Medicare was already underfunded $15 trillion to $20 trillion when the Medicare prescription drug bill was passed. We cannot afford the doughnut, much less to fill the doughnut hole with jelly.



This figure shows the Social Security surplus. The budget will start to suffer withdrawal pains in 2009 because starting in 2009 the Social Security surplus will start to decline. In 2017 the Social Security surplus will be gone and therefore we will have to redeem these bonds. That means raise taxes, cut other spending, or borrow more from foreign players.

By the way, before I summarize, if you take that $50 trillion number, let me benchmark that for you because frankly it is too big for anybody to relate to. Fifty trillion dollars is 95 percent of the total net worth of every American, up from 91 percent last year. Fifty trillion dollars is $440,000 per American household.

The median household income in America is less than $47,000. That is like having an implicit debt or mortgage equal to over nine times your annual income. And like a mortgage, it will be paid out over a number of years. But unlike a mortgage, there is no house to back this debt. It is only your citizenship and your ability to earn and the opportunity that one is given by being a citizen of the United States to reach one's full potential.

In summary, our financial condition is worse than advertised. We are on an imprudent and unsustainable long-term fiscal path. We cannot grow our way out of this problem. Anyone who says we can grow our way out of this problem has not studied economic history and probably is not very proficient at math. The numbers do not come close to working under reasonable assumptions.

Yes, we want to maximize economic growth. Yes, we want to minimize tax burdens. But in the final analysis you have to have enough revenue to pay your current bills and deliver on your promises for the future.

We need to enhance truth and transparency in our financial reporting and budgeting processes. We need to reimpose meaningful budget controls on both sides of the ledger and impose those controls not just on discretionary spending but also impose mandatory reconsideration triggers for mandatory spending both that done directly and that done indirectly through tax preferences. We need to reengineer and reprioritize the base of the Federal Government because it is based on the 1940's through the 1970's and most of Government is not necessarily generating positive results that can be identified.

We have to reform entitlement programs. We have to reengineer and constrain spending. And we have to engage in comprehensive tax reform that hopefully will generate more revenues in an economically efficient manner.

We are going to have to do all three because the numbers do not come close to working if you just focus on one or two of the three. And the longer you wait, the bigger the gap you are going to have to close. And the longer you wait, the less transition time you have. And the longer you wait, the more people who are vested in the status quo.

So the time to act is now, not just for the country but also for our kids and our grandkids.

Thank you.

[The prepared statement of Mr. Walker follows:]

United States Government Accountability Office

GAO

Testimony
Before the Committee on Budget, United States Senate

For Release on Delivery
Expected at 10:30 a.m. EST
Thursday, January 11, 2007

LONG-TERM BUDGET OUTLOOK

Saving Our Future Requires Tough Choices Today

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

GAO
Accountability * Integrity * Reliability

GAO-07-342T

Chairman Conrad, Senator Gregg, Members of the Committee,

I appreciate this invitation to talk with you about our nation's long-term fiscal outlook and the challenge it presents. Your decision to begin this Congress with a hearing on this important issue demonstrates the seriousness with which this Committee views this challenge and your commitment to begin to address it.

The picture I will lay out for you today is not a pretty one and it's getting worse with the passage of time. But this nation has met difficult challenges—including challenges to its very existence—in the past and I'm confident that we can do so again.. This is a great nation with much to be proud of and much to be thankful for. But today we are failing in one of our most important stewardship responsibilities—our duty to pass on a country better positioned to deal with the challenges of the future than the one we were given. As members of this Committee know, continuing on our current fiscal path would gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately even our domestic tranquility and our national security.

My "bottom line" message today is no surprise to members of this Committee:

- Our current financial condition is worse than advertised
- Our long-term fiscal outlook is both imprudent and unsustainable
- Improvements in information and processes are needed and can help
- Meeting our long-term fiscal challenge will require tough choices, bi-partisan cooperation and compromise,
- The time for action is now!

As widely reported the $248 billion fiscal year 2006 unified budget deficit was lower than originally forecast and lower than last year's deficit of $318 billion. While this improvement in the one-year fiscal picture is better than a worsening in that picture, it did not fundamentally change our long-term fiscal outlook. In fact, the U.S. government's total reported liabilities, net social insurance commitments, and other fiscal exposures continue to grow and now total approximately $50 trillion, representing approximately four times the Nation's total output (GDP) in fiscal year 2006, up from about $20 trillion, or two times GDP in fiscal year 2000.

The overall picture of the long-term fiscal outlook is not news to this Committee. However, the long-term challenge is fast becoming a short-term one as the first of the baby boomers become eligible for early retirement under Social Security on January 1, 2008—less than one year—and for Medicare benefits in 2011—less than 4 years from now. The budget and economic implications of the baby boom generation's retirement have already become a factor in CBO's 10-year baseline projections and will only intensify as the baby boomers age. Simply put, our nation is on an imprudent and unsustainable fiscal path. Herbert Stein once said that something that is not sustainable will stop. That, however, should not give us comfort. It is prudent to change the path than to wait until some crisis comes.

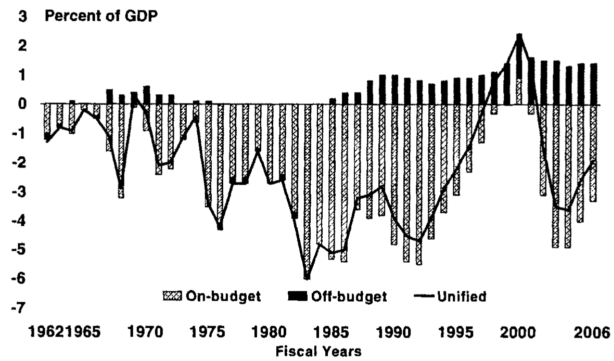
And that brings me to my next point. While restraint in the near term and efforts to balance the budget over the next 5 years can be positive, it is important that actions to achieve this also address the long-term fiscal outlook. The real problem is not the near-term deficit—it is the long-term fiscal outlook. It is important to look beyond year 5 or even year 10. Both the budget and the budget process need more transparency over and focus on the long-term implications of current and proposed spending and tax policies. I will suggest a number of things that I believe will help in this area in this testimony.

OUR FISCAL AND FINANCIAL CONDITION IS WORSE THAN ADVERTISED

Our government produces two types of measures—budget and financial—which further break down into three different numbers that can be seen as indicators of our current financial condition: the unified budget deficit, the on-budget deficit and the net operating cost or accrual deficit. No one of these alone is enough–we should look at all of them. The most commonly reported measure is the unified budget deficit. This is a largely cash-based number that represents the difference between revenues and outlays for the government as a whole. It is an important measure since it is indicative of the government's draw on today's credit markets—and its claim on today's economy. This measure, however, masks the difference between Social Security's cash flows and those for the rest of the budget. Therefore we also need to look beneath the unified deficit at the on-budget deficit—what I like to call the "operating deficit." And, finally, we should be looking at the financial statement's report of net operating cost—the accrual-based deficit.

The difference between the on-budget deficit and the unified budget deficit is the surplus in Social Security and the Postal Service. Excluding consideration of the $185 billion surplus in Social Security's cash flows and a $1 billion surplus in the Postal Service, the on-budget deficit was $434 billion in 2006. Figure 1 shows graphically how the on-budget deficit and the off-budget surplus have related and combine to lead to the unified deficit. Since the Social Security Trust Fund invests any receipts not needed to pay benefits in Treasury securities, this surplus reduces the amount the Treasury must borrow from the public. As I will note later, this pattern of cash flows is important—and it is projected to come to and end just 10 years from now.

Figure 1: Surplus or Deficit as a Share of GDP Fiscal Years 1962-2006



Source: Office of Management and Budget, Department of the Treasury and the Congressional Budget Office.

The third number, net operating cost, is the amount by which costs exceed revenue and it is reported in the federal government's financial statements which are prepared using generally accepted accounting principles (GAAP). Costs are recorded on an accrual basis—namely, in the period when goods are used or services are performed as opposed to when the resulting cash payments are made. However, most revenues, on the other hand, are recorded on the modified cash basis—that is, they are recorded when collected. The net operating cost can be thought of as the accrual deficit. The accrual measure primarily provides more information on the longer-term implications of today's policy decisions and operations by showing certain costs incurred today but not payable for years to come, such as civilian and military pensions and retiree health care.[1]

[1] For a discussion of how the accrual and cash deficits relate to each other see GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-97-117SP (Washington, D.C.: December 2006) and forthcoming update.

All three of these numbers are informative. However, neither the accrual nor the cash budget deficit alone provides a full picture of the government's fiscal condition or the cost of government. Used together, they present complementary information and provide a more comprehensive picture of the government's financial condition today and fiscal position over time. For example, the unified budget deficit provides information on borrowing needs and current cash flow. The accrual deficit provides information on the current cost of government, but it does not provide information on how much the government has to borrow in the current year to finance government activities. Also, while accrual deficits provide more information on the longer-term consequences of current government activities, they do not include the longer-term cost associated with social insurance programs like Social Security and Medicare. In addition, they are not designed to provide information about the timing of payments and receipts which can be very important. Therefore, just as investors need income statements, statements of cash flow, and balance sheets to understand a business's financial condition, both cash and accrual measures are important for understanding the government's financial condition.[2] Figure 2 below shows the three measures for FY 2005 and FY 2006.

Figure 2: Fiscal Year 2005 and 2006 Deficits and Net Operating Cost ($ Billion)

	Fiscal Year 2005	**Fiscal Year 2006**
On-Budget Deficit	(494)	(434)
Unified Deficit	(318)	(248)
Net Operating Cost[a]	(760)	(450)

Sources: The Office of Management and Budget and the Department of the Treasury.

[a] Fiscal year 2005 net operating cost included a significant negative actuarial adjustments and 2006 included a significant positive adjustments primarily due to changes in interest rate assumptions.

[2] GAO is responsible for auditing the financial statements included in the Financial Report, but we have been unable to express an opinion on them for ten years because the federal government could not

Although looking at both the cash and accrual measures provides a more complete picture of the government's fiscal stance today and over time than looking at either alone does, even these together do not tell us the full story. For example, all of these show an improvement been FY 2005 and FY 2006. However, the fundamental drivers of our long-term challenge are largely the same. To understand the long-term implications of our current path requires more than a single year's snapshot. In this regard, the long-term outlook has worsened significantly in the last several years. That is why for more than a decade GAO has been running simulations to tell this longer-term story.

THE LONG-TERM FISCAL OUTLOOK

Long-term fiscal simulations by GAO, CBO and others all show that we face large and growing structural deficits driven primarily by rising health care costs and known demographic trends. GAO runs simulations under 2 sets of assumptions; one takes the legislatively-mandated baseline from CBO for the first 10 years and then keeps discretionary spending and revenues constant as a share of GDP while letting Social Security, Medicare, and Medicaid grow as projected by the Trustees and CBO under mid-range assumptions.[3] The other—perhaps more realistic scenario based on the Administration's announced policy preferences—modifies this baseline by letting discretionary spending grow with the economy and extending all expiring tax provisions.[4] As Figure 3 shows, deficits spiral out of control under either scenario. We will be updating these figures with the release of the new CBO baseline later this month, but even with the lower deficit in 2006, the long-term picture will remain daunting.

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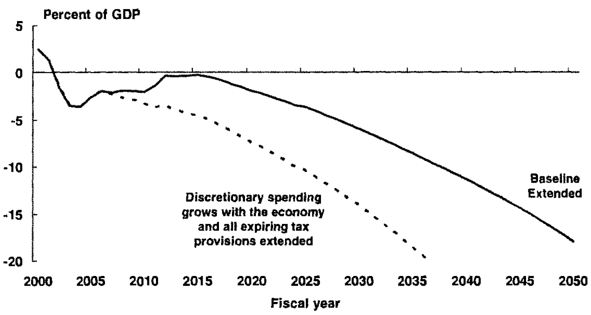
demonstrate the reliability of significant portions of the financial statements, especially in connection with the Department of Defense. Accordingly, amounts taken from the Financial Report may not be reliable.
[3] Social Security and Medicare spending is based on the May 2006 Trustees' intermediate projections. Medicaid spending is based on CBO's December 2005 long-term projections under mid-range assumptions.
[4] Additional information about the GAO model, its assumptions, data, and charts can be found at http://www.gao.gov/special.pubs/longterm/.

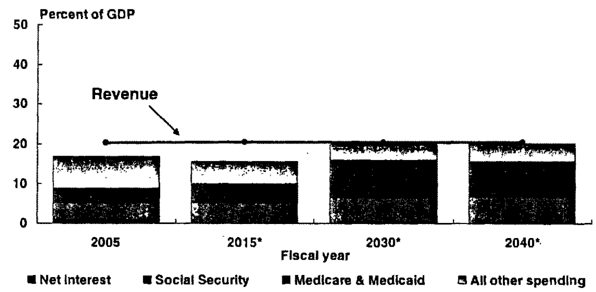
Figure 3: Unified Surpluses and Deficits as a Share of GDP Under Alternative Fiscal Policy Simulations



Looking more closely at each scenario gives a fuller understanding of what the impact of continuing these trends would have on what government does. And looking back to 2001 also shows us how much worse the situation has become. As I noted, despite some recent improvements in short-term deficits, the long-term outlook is moving in the wrong direction.

Figures 4 and 5 show the composition of spending under our "Baseline Extended" scenario in 2001 and 2006. Even with short-term surpluses, we had a long-term problem in 2001, but it was more than 40 years out. Certainly an economic slowdown and budget decisions driven by the attacks of 9/11 and the need to respond natural disasters have contributed to the change in outlook. However, these items alone do not account for the dramatic worsening. Tax cuts also contributed but the single largest contributor to the deterioration of our long-term outlook was the passage of the Medicare Prescription Drug Bill in 2003.

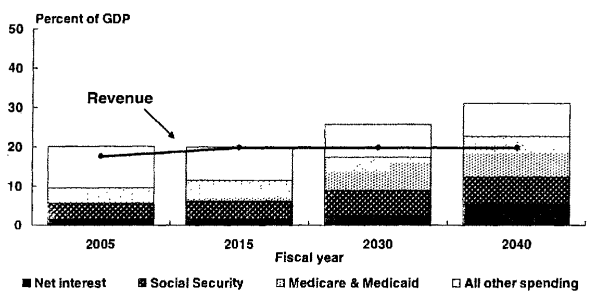
Figure 4: Composition of Spending as a Share of GDP Under Baseline Extended, January 2001



*All other spending is net of offsetting interest receipts.

Source: GAO's January 2001 analysis.

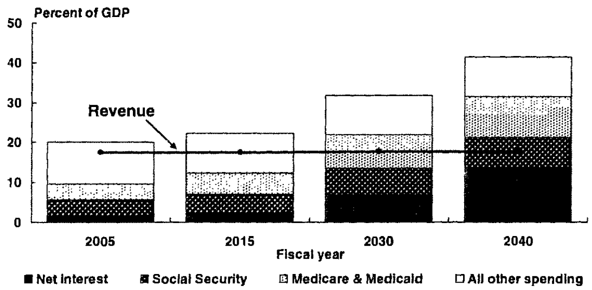
Figure 5: Composition of Spending as a Share of GDP under Baseline Extended, August 2006



Source: GAO's August 2006 analysis.

Figure 6 illustrates today's cold hard truth, that neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. This is even clearer under the more realistic scenario as shown in Figure 7. Estimated growth in the major entitlement programs results in an unsustainable fiscal future regardless of whether one assumes future revenue will be somewhat above historical levels as a share of the economy as in the first simulation (fig. 6) or lower as shown in figure 7.

Figure 7: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP After 2006 and All Expiring Tax Provisions are Extended



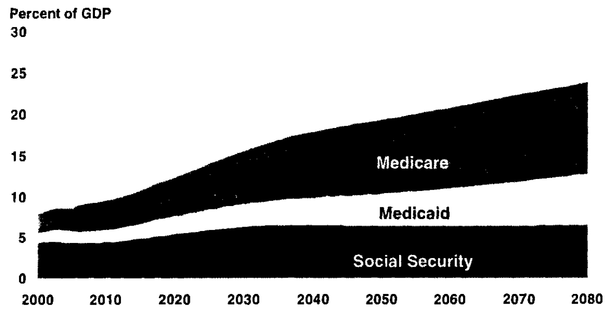
Source: GAO's August 2006 analysis.

Both these simulations illustrate that without policy changes on the spending and/ or revenue side of the budget, the growth in spending on federal retirement and health entitlements will encumber an escalating share of the government's resources. A government that in our children's lifetimes does nothing more than pay interest on its debt, mail checks to retirees, and to some of their health providers is unimaginable.

Although Social Security is a major part of the fiscal challenge, contrary to popular perception, it is far from our biggest challenge. Spending on the major federal health programs (i.e., Medicare and Medicaid) represents a much larger and faster growing problem. Over the past several decades, health care spending on average has grown much faster than the economy, absorbing increasing shares of the Nation's resources, and this rapid growth is projected to continue. For this reason and others, rising health care costs pose a fiscal challenge not just to the federal budget but also to states, American business, and our society as a whole.

While there is always some uncertainty in long-term projections, two things are certain: the population is aging and the baby boom generation is nearly at retirement age. The aging population and rising health care spending will have significant implications not only for the budget, but also the economy as a whole. Figure 6 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2006 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, federal spending for these entitlement programs combined will grow to 15.5 percent of GDP in 2030 from today's 9 percent. It is clear that, taken together, Social Security, Medicare, and Medicaid under current law represent an unsustainable burden on future generations.

Figure 6: Social Security, Medicare, and Medicaid Spending as a Percent of GDP



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

Notes: Social Security and Medicare projections based on the intermediate assumptions of the 2006 Trustees' Reports. Medicaid projections based on CBO's August 2006 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under mid-range assumptions.

While Social Security, Medicare and Medicaid dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending and potentially limit long-term budget flexibility. GAO has described the range and measurement of such fiscal exposures—from explicit liabilities such as environmental cleanup requirements to the more implicit obligations presented by life-cycle costs of capital acquisition or disaster assistance.

As shown in figure 7, despite improvement in both the fiscal year 2006 reported net operating cost and the cash-based budget deficit, the U.S. government's major reported liabilities, social insurance commitments, unfunded promises, and other fiscal exposures continue to grow. They now total approximately $50 trillion—about four times the Nation's total output (GDP) in fiscal year 2006—up from about $20 trillion, or two times GDP in fiscal year 2000. We all know that it is hard to make sense of what "trillions" means. One way to think about it is: if we wanted to put aside today enough to cover these promises, it would take $170,000 for each and every American or approximately $440,000 per American household. Clearly, despite recent progress on our short-term deficits, we have been moving in the wrong direction in connection with our long-range imbalance in recent years.

Figure 7: Major Reported Fiscal Exposures ($ Trillions)

	2000	2006	% Increase
• Explicit liabilities	$6.9	$10.4	52
• Publicly held debt • Military & civilian pensions & retiree health • Other			
• Commitments & contingencies	0.5	1.3	140
• E.g., PBGC, undelivered orders			
• Implicit exposures	13.0	38.8	197
• Future Social Security benefits	3.8	6.4	
• Future Medicare Part A benefits	2.7	11.3	
• Future Medicare Part B benefits	6.5	13.1	
• Future Medicare Part D benefits		7.9	
Total	$20.4	$50.5	147

Source: 2000 and 2006 Financial Report of the United States Government.

Note: Estimates for Social Security and Medicare are at present value as of January 1 of each year and all other data are as of September 30. Totals and percent increases may not add due to rounding.

PROCESS AND PRESENTATIONAL CHANGES TO INCREASE TRANSPARENCY AND FOCUS ON LONG-TERM CONSEQUENCES CAN HELP

Since at its heart the budget debate is about the allocation of limited resources, the budget process can and should play a key role in helping to address our long-term fiscal challenge and the broader challenge of modernizing government for the 21st Century. I have said that Washington suffers from myopia and tunnel vision. This is can be especially true in the budget debate in which we focus on one program at a time and the deficit for a single year or possibly the costs over 5 years without asking about the bigger picture and whether the long term is getting better or worse. We at GAO are in the transparency and accountability business. Therefore it should come as no surprise that I believe we need to increase the understanding of and focus on the long term in our policy and budget debates. To that end—as I noted earlier—I have been talking with a number of members of the Senate and the House as well as various groups concerned about this issue concerning a number of steps that might help. I attach a summary of some of these ideas to this statement. Let me highlight several critical elements here.

- The President's budget proposal should again cover 10 years. This is especially important given that some policies—both spending and tax—cost significantly more [or lose significantly more revenue] in the second 5 years than in the first. In addition, the budget should disclose the impact of major tax or spending proposals on the short, medium and long term.
- The executive branch should also provide information on fiscal exposures—both spending programs and tax expenditures—i.e. the long-term budget costs represented by currently individual programs, policies or activities as well as the total.
- The budget process needs to pay more attention to the long-term implication of the choices being debated. For example, elected representatives should be provided with more explicit information on the long-term costs of any major tax or spending proposal before it is voted upon. It is sobering to recall that during the debate over adding prescription drug coverage to Medicare, a great deal of attention was paid to whether the 10-year cost was over or under $400 billion. Not widely publicized—and certainly not surfaced in the debate-- was that the present value of the long-term cost of this legislation was about $8 trillion!

Of course, when you are in a hole, the first thing to do is stop digging. I have urged reinstitution of the statutory controls—both meaningful caps on discretionary spending and PAYGO on both the tax and spending sides of the ledger—that expired in 2002. Given the severity of our current challenge, Congress may wish to look beyond the return to PAYGO and discretionary caps. Mandatory spending cannot remain on autopilot. We have suggested that Congress might wish to design "triggers" for mandatory programs—some measure that would prompt action when the spending path increased significantly. In addition, Congress may wish to look at rules to govern the use of "emergency supplementals." However, as everyone in this committee knows, these steps alone will not solve the problem. That is why building in more consideration of the long-term impact of decisions is necessary.

MEETING THE LONG-TERM FISCAL CHALLENGE REQUIRES COOPERATION AND COMPROMISE—AND ACTION SHOULD NOT BE DELAYED.

The government can help ease future fiscal burdens through spending reductions and/or revenue actions that reduce debt held by the public, and enhancing the pool of economic resources available for private investment and long-term growth. Economic growth is essential, but we will not be able to simply grow our way out of the problem. The numbers speak loudly: our projected fiscal gap is simply too great. To "grow our way out" of the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II.

While the appropriate level of revenues will be part of the debate about our fiscal future, making no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require ever increasing tax levels—and that seems both inappropriate and implausible. Accordingly, substantive reform of Social Security and our major health programs remains critical to recapturing our future fiscal flexibility. Similarly, given demographic and health care cost trends, the size of the spending cuts necessary to hold revenues at the share of GDP seems inadequate and implausible. Waiting only makes matters worse. GAO's simulations show that if no action is taken, balancing the budget in 2040 could require actions as large as cutting total federal spending by 60 percent or raising federal taxes to 2 times today's level. There are no "easy answers," and everything must be on the table.

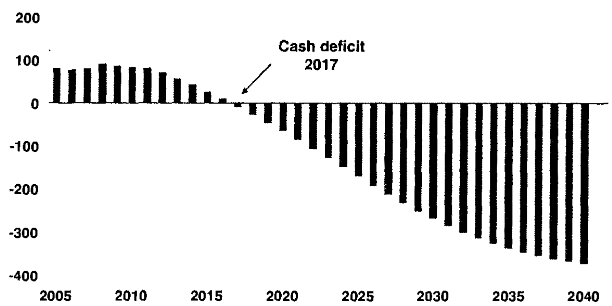
Although the long-term outlook is driven by Social Security and health care costs, this does not mean the rest of the budget can be exempt from scrutiny. Many tax expenditures operate like entitlement programs—but with even less scrutiny. Other programs and activities were designed for a very different time. To recapture our fiscal flexibility and bring our government and its programs in line with 21st century realities requires a fundamental reexamination of major spending and tax policies and priorities.[5] Ultimately this reexamination will entail a national discussion about what Americans want from their government and how much they are willing to pay for those things. This discussion will not be easy, but it is critical.

For many years those of us who talk about the need to put social Security on a sustainable course and to reform Medicare have talked about the benefits of early action. Acting sooner rather than later can turn compound interest from an enemy to an ally. Acting sooner rather than later permits changes to be phased in more gradually and those affected to adjust to the changes. Delay does not avoid action—it just makes the steps that have to be taken more dramatic and potentially harder. Unfortunately, there has already been too much delay. And now the future is upon us.

Next year members of the baby generation start to leave the labor force. Reflecting this demographic shift, CBO projects the average annual growth rate of real GDP will decline from 3 percent in 2008 to 2.6 per cent in the period 2012-2016. This slowing of economic growth will come just as spending on Social Security, Medicare and Medicaid will begin to accelerate—accounting for 56 percent of all federal spending by 2016 compared to 43 percent in 2006.

As I noted earlier, today Social Security's cash surplus helps offset the deficit in the rest of the budget, but growth in Social Security spending is expected to increase from an estimated 4.8 percent in 2008 to 6.5 percent in 2016. The result, as shown in figure 8 below, is that the Social Security surpluses begin a permanent decline in 2009. At that time the rest of the budget will begin to feel the squeeze since the capacity of Social Security surpluses to offset deficits in the rest of the budget will begin to shrink. In 2017 Social Security will no longer run a cash surplus and will begin adding to the deficit. That year the Social Security will need to redeem the special securities it holds in order to pay benefits. Treasury will honor those claims—the U.S. has never defaulted. But there is no free money. The funds to redeem those securities will have to come from higher taxes, lower spending on other programs, higher borrowing from the public or a combination of all three.

Figure 8: Projected Cash Surpluses and Deficits in the Combined Social Security Trust Fund (Billions of 2006 dollars)



Note: Projections based on the intermediate assumptions of the 2006 Trustees' Reports. The CPI is used to adjust from current to constant dollars.

Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration.

[5] Cite 21st century challenges AND the oversight letter here

CONCLUDING REMARKS

It is a hopeful sign that we are here today—by beginning the year not with a discussion of the current year's budget but with a focus on the long term this Committee is showing the kind of leadership needed to tackle this challenge.

I have long believed that the American people can accept difficult decisions as long as they understand why such choices are necessary. They need to be given the facts about the fiscal outlook: what it is; what drives it; what it will take to address it. As most of you know, I have been investing a good deal of time in the Fiscal Wake -Up Tour (FWUT) led by the Concord Coalition. Scholars from both the Brookings Institution and The Heritage Foundation join with me and Concord in laying out the facts and discussing the possible ways forward. In our experience, having these people with quite different policy choices agree on the nature, scale and importance of the issue—and on the need to sit down and work together—resonates with the audiences. Although the major participants have been Concord, GAO, Brookings and Heritage, others include such organizations as the Committee for Economic Development (CED), American Institute of Certified Public Accountants (AICPA), the Association of Government Accountants (AGA), the National Association of State Comptrollers and Treasurers (NASCT), State Auditors, and AARP. The FWUT also has received the active support and involvement of community leaders, local colleges and universities, the media, the business community and both former and current elected officials. We have been to 17 cities to-date. The discussion has been broadcast on public television stations in Atlanta and Philadelphia. Just this morning I returned from an event at The John Glenn School of Public Affairs at Ohio State University in Columbus, Ohio in which OMB Director Portman and former Senator Glenn participated.

The specific policy choices made to address this fiscal challenge are the purview of elected officials. The policy debate will reflect differing views of the role of government and differing priorities for our country. What the FWUT can do—and what I will continue to do—is lay out the facts, debunk various myths and prepare the way for tough choices by elected officials. If the American people understand that there is no magic bullet—if they understand that:

- we cannot grow our way out this problem;
- eliminating earmarks will not solve the problem
- wiping out fraud, waste & abuse will not solve the problem;
- ending the war or cutting way back on defense will not solve the problem

and

- letting the recent tax cuts expire will not solve this problem

Then they can engage with you in a decision about what government should do and how.

This is a great nation. We have faced many challenges in the past and we have met them. It is a mistake to underestimate the commitment of the American people to their children and grandchildren; to underestimate their willingness and ability to hear the truth and support the decisions necessary to deal with this challenge. We owe it to our country, children and grandchildren to address our fiscal and other key sustainability challenges. The time for action is now.

Mr. Chairman, Senator Gregg, members of the Committee, let me repeat my appreciation for your commitment and concern in this matter. We at GAO stand ready to assist you in this important endeavor.

ATTACHMENT I: Ideas for improving the transparency of long-term costs and the attention paid to these costs before decisions are made

Supplemental reporting in the President's annual budget submission

- Produce an annual Statement of Fiscal Exposures: including a concise list and description of exposures, cost estimates where possible, and an assessment of methodologies and data used to produce such cost estimates.

- Increase the transparency of tax expenditures by including them in the annual Fiscal Exposures Statement and, where possible, also showing them along with spending and credit programs in the same policy area.

- Provide information on impact of major tax or spending proposals on short-term, mid-term, and long-term fiscal exposures and on the path of surplus/deficit and debt as % of GDP over 10-year and longer term horizons (and assuming no sunset if sunset is part of the proposal).

- Cover 10 years in the budget

- Consider requiring the President to include in his annual budget submission a long-term fiscal goal (e.g., balance, surplus, or deficit as % of GDP).

Additional Executive branch reports

- Preparation & publication of a Summary Annual Report or Citizen's Summary that summarizes, in a clear, concise, plain English, and transparent manner, key financial and performance information included in the Consolidated Financial Report.

- Preparation and publication of a report on long-range fiscal sustainability every 2 to 4 years.

Additional cost information on proposals before adoption

- Require improved disclosure—at the time proposals are debated but before they are adopted—of the long-term costs of individual mandatory spending and tax proposals over a certain size and for which costs will ramp up over time.

GAO reports

An annual report or reports by GAO including comments on the Consolidated Financial Statement (CFS), results of the latest long-term fiscal simulations, comments on the adequacy of information regarding long-term cost implications of existing and proposed policies in the previous year as well as any other significant other financial and fiscal issues .

* * *

In previous reports GAO has also suggested that Congress might wish to consider changing the budget treatment in certain areas

- Use accrual budgeting for areas where cash basis obligations do not adequately represent the government's commitment:
  - Employee pension programs (pre-FERS employees)
  - Retiree health programs
  - Federal insurance programs, such as PBGC and crop insurance
- Explore techniques for expanding accrual budgeting to:
  - Environmental cleanup
  - Social insurance - could consider deferring recognition of social insurance receipts until they are used to make payments in the future (this was suggested in GAO's accrual budgeting report as an idea to explore, possibly with a commission designed to explore budget concepts).

* * *

Senator CONRAD. General Walker, thank you for that really outstanding testimony. This is precisely why we wanted to have you as the first witness before this committee, to lay out clearly and concisely and in a compelling way the seriousness of the challenge confronting us.

Let me go back to a couple of the statements you made. Yesterday or perhaps the day before I read in one of the major newspapers, the Washington Post, they had a little sidebar story in which they said, the deficit is only 1.8 percent of GDP and economists say that that is sustainable indefinitely. True or not true? Misleading or not misleading? How would you characterize that? If you were to write the story trying to advise people of our fiscal condition, how would you characterize it?

General WALKER. It is accurate but misleading. We probably can sustain a deficit of less than 2 percent of GDP for a number of years. But that is not where we are headed. Where we are headed is to deficits of multiple times 2 percent of GDP. As both of you have noted, Chairman Conrad and Chairman Gregg, we are headed to the point where Social Security, Medicare, and Medicaid alone will consume all of the historical Federal revenues as a percentage of the economy.

And that does not count interest on the Federal debt. The fastest-growing cost in the Federal budget today is interest on the Federal debt. It went up from 7 percent of the budget in 2005 to 9 percent in 2009. And we have relatively modest interest rates.

When, not if, foreign investors decide, as a matter of mere prudence and diversification, that they are not going to continue buying as much U.S. debt, then interest rates will rise and that will start a compounding effect. So what is important is that we act so to mitigate the impact and to help avoid their seeking to hold less of our debt. We can. We must. I think we will, hopefully, with bipartisan leadership.

Senator CONRAD. General Walker, you have outlined here what the risk is to the economy, that increasingly we are financing this debt abroad. Fifty-two percent is the latest figure I have, 52 percent of our debt is now financed abroad. We have doubled the amount of our borrowing from foreign countries in the last 5 years—doubled. We borrowed 65 percent of all of the money that was borrowed by countries in the world last year.

So to me it is clearly an unsustainable course now. And that is before the baby boomers retire. How much more serious does it become as the baby boomers become eligible for these programs?

General WALKER. It becomes clearly unsustainable. Basically what is going on right now is we have a national credit card. But unlike most credit cards it does not have a credit limit. And so we are continuing to charge our national credit card, compounding interest. But we are expecting our kids and our grandkids to pay it off.

We have four deficits today that relate to your point: (1) a budget deficit which we have talked about, (2) a balance of payments deficit of which the trade deficit is a subset, (3) a savings deficit. In 2005 for the first time since 1933, which was not a good year for America, Americans spent more money than they took home last year.

And (4) the worst deficit of all is the leadership deficit. That is what we have to address on a bipartisan basis because Social Security, Medicare, and Medicaid represent a tsunami of spending. And, unlike most tsunamis, this one never recedes. It is a permanent change in the landscape.

What is going on now is as if we are on the beach and we are saying, let us just focus on the short-term. We are making progress on the short-term, but right on the horizon we can see this tsunami building. We need to recognize reality and start to act to deal with that.

Senator CONRAD. Final question from me. General Walker, Senator Gregg and I and others have been talking about a structure that would be a bipartisan effort to devise a plan to address our long-term fiscal imbalances, including but not limited to Medicare and Social Security, also looking at the structural deficit, and ask the group—Republicans and Democrats equally divided—to come back with a plan that would require a super-majority vote here to pass.

Would you endorse such an effort? Do you think it is important that we make that attempt in this year?

General WALKER. I think it is important to figure out mechanisms that will allow the Congress to be able to deal with this issue sooner rather than later. Realistically those mechanisms must involve the both executive and the legislative branches. They must be bipartisan in nature. At least the recommended package, I would respectfully suggest, should be subjected to a super-majority vote of the members who comprise this group.

Senator CONRAD. And it would.

General WALKER. Whether or not you should require a super-majority vote once it gets to the Congress is a different issue. I think you clearly need a super-majority vote on something that comes to the Congress but I think it is a different issue as to whether or not you should require a super-majority vote once it gets to the Congress. Obviously you have to be concerned to make sure that the President is not going to veto the package because then you would have to have a super-majority vote. All the more reason why you have to have the President engaged in this. Expedited consideration I think would clearly be a desirable feature; no doubt about that.

So without knowing the details, I think that to the extent that you could put together something without a commission, that is desirable. But we have to figure out how to get it done and how to get it done sooner rather than later in a bipartisan manner.

Senator CONRAD. I thank you for that and I want to make clear that it would require a super-majority of the group that would be given the responsibility to come up with a plan. It would involve the White House. The President would have members of this working group.

The reason for both a super-majority from the group and a super-majority when you come back is if it is on an expedited basis and you are restricting members' right to amend, which is the most fundamental right of a Senator, people are not going to give up that without the assurance that there is going to be a tough hurdle here to pass. That is the reality that we confront here.

I just think what you say is absolutely the case. The sooner we get at this the better. Those things we cannot agree on will have to wait.

Senator Gregg.

General WALKER. Senator, if I may just add something quickly, sir. I understand what you are saying about why you are proposing a super-majority vote of this body and the other body. Obviously, one of the possible tradeoffs for your consideration is limited amendments and not requiring a super-majority vote. That is something I would respectfully suggest you may want to think about.

The other thing is the scope. Does it include all of the elements that I talked about? I think it is important that it include all of the elements that I talked about: more transparency in financial reporting and the budget process, strong budget controls on both sides of the ledger, discretionary and mandatory spending including entitlements, and tax preferences. I think it is really important that all of these items be on the table in order to be able to get to the point where we can really do something meaningful and where you can achieve the vote requirement.

Senator CONRAD. Thank you. Senator Gregg.

Senator DOMENICI. Senator Gregg, I wonder if you would yield 30 seconds so I can ask the chairman a question.

Chairman GREGG. I am sure the chairman will allow it at this time.

Senator DOMENICI. I just wondered, so the whole public will know, you keep using and we all keep using the word it. We have to do it. What is it?

Senator CONRAD. It is to address these long-term entitlement challenges, these long-term fiscal imbalances, but not limited to Medicare and Social Security, but including the imbalances between projected revenue and expenditures so that we are getting at not only the long-term entitlements but the structural deficits that we have going into this process as well, with everything on the table.

Senator DOMENICI. Senator, I just want to try one more time because I think if it was as easy as you say we would just do it. The problem is when you put this budget together or this instrument that solved the problem of the world toward America, what are we going to have to do to Social Security? What are we going to have to do to Medicare? We are talking about fixing it. When we look at there at Americans we say we are not going to be able to afford Medicare in its current form. So what is going to happen? Generally, what do we have to do?

Senator CONRAD. I would just say to the Senator, we cannot give the results of the exercise before we have started the exercise. We cannot give an answer to what the solutions are until we devise a process to have a proposal brought back before the Congress.

So I do not think you can say what the conclusions are until we begin and engage in the process. And do it together and do it in a very serious way.

Chairman GREGG. Just to followup on that, I think the issue here is to set up a procedure that drives policy. But the key to the procedure is that it be unquestionably bipartisan, that nobody feels they are being gamed, that the American people feel that when the procedure is concluded and the policy is proposed that it has been reached in a way that is totally fair. That means you have to have the presidency in the room and you have to have the Congress in the room.

The situation that we have now is that we have a divided government where that type of fairness is inherent in the process if everybody's in the room and the structure is such that you have super majorities for reporting and for passage.

So I think the opportunity is here and let us hope somebody takes advantage of it.

Senator DOMENICI. Thank you.

Chairman GREGG. If I could pursue some of the thoughts you had, Mr. General, to get a little bit into the weeds here, historically we have had 18.2 percent of gross domestic product in tax revenue. For the last few years we have had 20 percent in spending. If we are on this path of entitlement spending, we are looking at 28, 29, 30 percent spending, which is not sustainable. We all know that.

The question becomes at some point—we are going to have to make a decision where these lines should appropriately cross. In other words, the only way you are going to solve the out year imbalance of liability and revenue is to pick a number which is sustainable and which maintains a strong economy for expenditures and revenues that is the same. I mean, that is just the way it is.

So I guess my question to you is do have an idea, do you have a thought of what is a number where those lines cross that the economy maintains its strength, that you do not undermine the economy by having too large a government to support?

General WALKER. I understand.

Chairman GREGG. Looking in the historical terms of somewhere, I presume, between 18.2 percent and—

General WALKER. Let me try to provide you meaningful information here.

First, I believe that the imbalance is requires you to address all three issues that I mentioned. You are going to have to get most of the money through entitlement reform. That has to be No. 1.

Second, you can and should get money from spending restructuring and constraint outside of entitlement reform.

And third, you are going to have to get more revenues hopefully through fundamental tax reform which, among other things, would broaden the base, try to keep rates as low as possible.

My personal view is you are going to need additional revenues; 18.2 percent of GDP will not get the job done even if you end up restructing entitlementa and constrain spending . The gap is just too great. It is going to have to be more than 18.2 percent.

I believe that you need to try to keep it as low as you can for three reasons. No. 1, to maximize economic growth. No. 2, to maximize disposable income. And No. 3, to maximize our competitive advantage compared to Europe.

Europe's tax levels are about 10 plus percent higher than ours when you compare Federal, State and local. They have much higher unemployment rates. They have slower growth rates and much higher employment rates. We need to learn from that.

Now, where will we end up? Is it 20 percent of GDP? Is it 22 percent of GDP? What the exact number is I cannot tell you. But it is more than 18.2 percent and it is below 25 percent.

Chairman GREGG. What I most appreciate is the lead in to it where you outline the issues, the spending restraint and the benefit reform and some sort of revenue reform.

When you are talking revenue reform, there has been proposals out there that we should maybe have a dedicated stream of revenue from a consumption tax. Have you ever thought of that? And what is your reaction to that?

General WALKER. There is absolutely, positively no question you are going to need more revenues for health care. If there is one thing that can bankrupt America, it is health care.

Frankly, you could reform Social Security and exceed the expectations of every generation of Americans without additional revenue. You may have to have additional revenue to get a political deal, but you do not need it to make it work. You are going to need it for health care.

In health care, candidly, I think there are four things we are ultimately going to have to shoot for in health care and it is going to take us probably 10 to 20 years to get to where we need to be in installments.

We are going to have to limit the percentage of the Federal budget that is dedicated to health care. If you do not do that, that is the ultimate put option on our children and grandchildren. Every other industrialized nation does that in some way. We ration health care today, we just do not ration it rationally.

Second, we need to try to move toward providing basic and essential health care coverage for everybody. Basic and essential. Inoculations against infectious diseases, wellness services, protection against financial ruin due to unexpected catastrophic illness where you are not using heroic measures, and ability to purchase more insurance if you want. Right now we spend 50 percent more of our economy on health care than any country on earth. We have the largest uninsured population.

By the way, the third element is quality. We need to achieve above average health care outcomes. Today, we are below average for an industrialized nation on health care outcomes. We have lower average life expectancy, higher than average infant mortality, and way higher than average medical error rates. Finally, increase personal responsibility and accountability for one's own health and wellness activities.

I believe that we can do this but it requires fundamentally rethinking Medicare and fundamentally rethinking what our future will look like 20-plus years from now and then taking installment steps to get there over years.

We are not going to be able to move from plan A to plan B overnight. It will have to be done in installments over a number of years. But this kind of system, quite frankly, I think could be affordable and sustainable. But where we are at now, no way.

Chairman GREGG. Thank you for that explanation. That was very cogent, to say the least.

Senator CONRAD. Senator Murray.

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

First of all, let me congratulate you on your leadership on this committee. I am glad you are the chair.

And Senator Gregg, I want to thank you for your tremendous respect of all of us on this committee under your leadership over the last several years, and look forward to working with you.

Mr. Chairman, I am interested in the process you have outlined for all of us to try and work our way forward under a very, very difficult scenario that General Walker has set out for us. And I want to thank you for being here today, and putting all of this in perspective as we move forward under very, very difficult—dismal I might say—budget situation that we have been left with after deficit spending for a number of years.

I think we know that unsustainable budget deficits have become the norm and we have to look at the long-term picture and make some very difficult and strategic decisions. And it cannot be done alone. We need to all work together to accomplish that.

Let me go from the macro down to a question I had because this situation that you have presented to us in this hearing comes within the timing of the President addressing us last night on his plan on his military efforts in Iraq. That will be debated outside of this committee, I am certain. We all have our opinions on that.

But I wanted to ask you, particularly in terms of the budget, about the realistic estimate of the long and short-term costs of the war in Iraq. Do you think Congress has a clear understanding of the cost estimates of the war? And are we budgeting for it in a way that is sustainable in the long term?

General WALKER. No, I do not think Congress has as good of an understanding of the cost of the war as it should have.

No. 2, I have serious concerns about some of the past numbers that have been associated with it and the numbers that we are hearing with regard to the most recent proposal. For example, I have heard that there will be a request for $5.6 billion associated with a surge of 21,500 troops.

Well, the average total annual compensation for a member of the active duty military is close to $120,000, fully loaded, with benefits and everything. It is about $1.2 billion per 10,000 troops. If you multiply that by 2.15, you do not get anywhere close to $5.6 billion.

Plus, on top of that, most of those people are already getting paid. Yes, you have to pay war zone supplementals, you have to get them there and back, you have to properly equip them—but that is less than the total dollar amount I cited.

But I honestly have to tell you, I think the defense budget is a serious problem. There is a tremendous amount of waste going on. And I think that it is important that as much of the defense budget get into the base as possible so that it can be subject to Congressional scrutiny and oversight.

Only time will tell how much longer we will be in Iraq and how much it will cost us. I do not think anybody knows that but God today.

Senator MURRAY. There is a number of different scenarios out there and the long-term budget projections that you are looking at today, what scenario were you basing those long-term projections—

General WALKER. CBO. We do not try to compete with CBO. We start with the CBO baseline and, as you know, they must assume, that whatever funding was provided for Iraq will continue.

And then what we do longer-term, Senator Murray, is we do not segment out Iraq or Afghanistan or the global war on terrorism. We basically make an assumption as to what is total discretionary spending going to be as a size of the economy? After the 1st 10 years it grows with the economy, we assume? So we do not get down to that level of detail long-term.

Senator MURRAY. Just as a quick followup, the CBO estimated that the care of the veterans from Iraq before the recent plan from the President is going to cost about $1 billion per year over the next 10 years. Have you looked at that and put that into your long-term?

General WALKER. I will be happy to provide something for the record, but the real question is how is it included in the CBO baseline? We are piggybacking on CBO. I will check it and provide something for the record.

General WALKER. GAO's long-term simulations do not make any assumptions about the path of any specific program within the "other" category shown in the figures. This "other" category includes both discretionary spending and mandatory programs other than Social Security, Medicare, Medicaid (and of course net interest). Under the "Baseline Extended" scenario we use the CBO baseline for the first 10 years. This baseline assumes that discretionary spending in the aggregate grows with inflation. After the first 10 years we keep the level of spending in this category constant as a share of GDP. Under the alternative scenario we assume that spending in this category grows with the economy for the first 10 years and the longer-term.

Senator MURRAY. I do think, Mr. Chairman, that is something we are going to have to look closely at and monitor as well, as we do this.

General WALKER. If I may add, Senator Murray too, and I think this is important, one of the reasons that the Defense Department budget is out of control is because of health care. It is one of many. And Congress passed expansion of TriCare benefits for defense.

I sent letters up to the Hill talking about that was going to just enable employees to exercise a huge put option on our kids and our grandkids, and that is exactly what is going on.

Senator CONRAD. Senator Domenici.

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

Mr. Walker, thank you so much for coming up. Over time I kind of wondered what your role was vis-a-vis this effort we are doing and that started back when we were not getting along too well. But I want to say to you that I think you are a big help. We have our own, they have their own, we have you. You have many other jobs besides this, but I think that you are very helpful.

Let me say first, as we all listen, that when we talk about having to do something with a long-term program such as Medicare, Medicaid, Social Security, it is not—fellow Americans, it is not that what we have to do is easy, or we would just do it.

The truth of the matter is that something has to change. Normally, when we look at that, we do not want to tell the American people that the program that saves America changes these programs so that over time they do not cost as much. That means something will change in the program that it will be different 10 years from now or 15 than it is now. We might as well say the truth: it will be less, probably less benefits.

That is why I was hinting when I was talking to you, not that you ever hide from it, Mr. Chairman. But when we speak of doing something to it, what we mean is doing something to the programs that people currently want because they are getting them. They like them and they fight for them. And we are just sitting here and saying to them well, they will keep on coming.

You keep telling us but when will it stop? And then we get people saying it is not going to matter, we are going to be able to take care of it. And then we are up here as budgeteers saying oh, but we have to make some changes. And in the middle of this line, good faith Senators are trying to figure out some formulation that would put this in a position where we could call upon ourselves in a meaningful way.

Nobody wants to be part of a program of trying to fix these programs when it is not going to fix them. That is a total, total political waste, so you will not do it. So it has to be something that will work; right?

And people have to feel like it will work when they join it. And I am not sure that people want to risk that much of their political strength. But they are going to have to.

I want to laud this Chairman and this ranking member and say if they can begin to put this together, they will go down much more in history than any of the other things that we are talking about that Government has to do.

I, myself, haveten so frustrated, Mr. Walker and Mr. Chairman, that I am planning to put together a bill with Senator Feinstein, and it is almost finished, and I will bring it to you all, which would set up the commission which would do this business for us and report to the public and to Congress on how to solve the problem. Sooner or later we are going to have to do that. Somebody is going to have to set it together and put it together and move on with it.

I have a brief summary that I would have given and I would like to put it in the record, Mr. Chairman, at this point.

And with that, thank you for giving me time. Mr. Walker, thanks again for your public service. It is admirable and we need it.

GENERAL WALKER. Thank you. If I can, Mr. Chairman, I think we have to be realistic. Senator Domenici, as you properly point out, we are talking about real tough choices here. Real tough choices, dealing with benefits, dealing with other spending, dealing with tax policy.

Realistically, whether you go the approach that you are talking about, Senator Conrad, or whether you go with the approach that you are talking about, Senator Domenici—one does not involve a commission and the other one does—I would respectfully suggest that you are not going to solve the problem in one fell swoop.

But I do think you could do several things as the first installment. Start by poroviding, additional transparency in a financial reporting and the budget. Second, impose tough budget controls to stop or slow the bleeding. In terms of sbstantive installment could do 3 things: First, a comprehensive Social Security reform that is not preprogrammed to have to come back. That is easily doable.

Second, round one of tax reform.

And third, round one of health care reform focused on Medicare and Medicaid. Those things, I believe, would mean a meaningful down payment, would provide more transparency and a structure in place to help you going forward, would be a credibility enhancer with the American people and a confidence builder for the Congress.

Senator CONRAD. Mr. Walker, let me just say that I think you have described very ably and very succinctly what would be realistic goals for this kind of effort.

Let me say to my colleague, Senator Domenici, who has been such an important force on this committee for so long, as chairman, as ranking member, as senior member, the notion of a commission, we decided that it would be better if it were all members, people that have skin in the game, rather than asking outside experts who ultimately are not accountable. Because it has to pass here. And we need the people who have responsibility here, and I include the White House. I want to make very clear that if the White House is not on board with his effort, there is no sense even beginning. Because ultimately the President has to agree to sign or to veto.

So everybody has to be on board. And Senator Domenici is exactly right. This is not easy. This is going to be excruciatingly difficult. But if we fail to act, kick this can down the road, that only makes the ultimate solution more draconian.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Mr. Walker, I applaud your remarks on the health care system. If there is one thing that can bankrupt America, it is health care. And you have identified a lot of the problems that our health care system is burdened with.

My view is that our health care system is ridiculous and that it would be disgraceful for the U.S. Congress to seek to cut health care spending without taking as hard a look as we can add at the reforms that are necessary to drive the costs down not with the tough budget knife but by actually making the system work better and be more efficient.

I think it is probably the most inefficient system in the world. Many years ago in Rhode Island, I led a reform of the workers compensation system. And we put discipline to that process by hiring actuaries who prices the reform legislation as it went. And we could not put that thing through until they had signed off on yes, this will save the money that you have said it will.

It is an imperfect discipline but it was a good discipline. I am wondering if your office is interested in and capable of providing that kind of discipline and support to a health care reform effort in this body?

General WALKER. First, Senator, we are here to support the Congress in any way that you think would be helpful. Obviously, most of our work, as you probably know, is focused on supporting the committees because those are the entities that end up moving legislation, holding hearings, et cetera. In addition, we do not want to compete with our sister agency, the Congressional Budget Office, which you know is the official scorekeeper for the Congress.

But I will tell you this, one of the things that you touch on is the need better metrics and for more disclosure of not just the 1-year, the 5-year and the even 10-year cost of proposals. We need a sense as to what the longer-term implications of any major policy or proposal would be.

One of the things I think we have to do, for example, Medicare prescription drugs. As you may recall, and I know you were not in this body then but I am sure you read the papers then.

Senator WHITEHOUSE. It is a thrill to arrive with this kind of problem looking at us.

General WALKER. You have a challenge and there is an opportunity.

Let me take that as an example because it goes to your point. Congress decided that it could spend several hundred billion dollars over 10 years on Medicare Part D when we had a surplus. When the bill passed we had a deficit. There were differences between what CBO said it was going to cost and what the actuary at Medicare said it was going to cost, but the actuary was not able to disclose his numbers. More importantly, there was never any discussion of the discounted present value dollar cost; not until three and a half months after the bill passed—and it was $8 trillion.

For big-ticket spending and tax items we need to have good numbers and those numbers need to go beyond on the short term to help us get a sense for affordability and sustainability over the long term.

And so yes, we are willing to help in any way we can. At the same point in time, we do not want to duplicate the efforts of our sister agency.

Senator WHITEHOUSE. The other question I have, as I said, the budget knife can be pretty unwieldy. If you want to cut your transportation budget in half you do not go out and cut your car in half. That takes you to zero transportation. You have to be a little bit more sophisticated about it and understand the underlying system.

My experience as an attorney general, particularly in education, was that very often we were saving money at the $7,000 per pupil level, say in a middle school, and losing so many kids through that school that then turned up at $100,000 per kid in the training school, and whose trajectory of life was dramatically compromised by their failure in middle school.

I have always surmised that the cost of losing them at that age and of their ceasing to be productive citizens and creating enormous law enforcement and other costs, was enormous. But I have never seen a calculation of that or a looking forward consequences analysis of where a failure to invest creates enormous costs later on, as opposed to simply cutting as you go.

General WALKER. I have not seen that either. I can go back and see if we have done anything on that in the past.

I do think this, Washington tends to suffer from two maladies: myopia, or nearsightedness, and tunnel vision where you are just looking narrowly at one issue at a time. One of the things we have to do, which you are touching on, we need to look longer range, and we need to understand the collateral effects of things that we do or we do not do.

Education, frankly, is a problem in and of itself because we are not even top 20 in the world in math and science. And yet we have to compete based on brain power in a more advanced economy. So there are a number of issues there I think that are worth exploring.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Senator CONRAD. Thank you, Senator.

Senator ALLARD.

Senator ALLARD. Mr. Chairman, thank you.

I just want to raise a word of caution as far as talking about things like infant mortality, disease occurrence, and hospital associated accidents or however you want to delineate them. Because many times the World Health Organization builds these off of records that are kept within the country.

And so you take a country like Mexico, who does not record births, does not record marriages, does not record deaths. These figures are not as accurate as what we have in this country, where we require physicians and health care professionals to report adverse reactions in hospitals. Infant deaths are recorded. We have had a birth certificate, a death certificate, where all of this is documented for the public record.

I do think that when we make comparisons with other countries that we can get some misleading figures there and I think we need to keep that in mind when we are working with those figures.

The thing I would like to bring up is that I agree with everything that has been said. We have a complicated problem. I think we have put this problem off to the point now where we cannot tax our way out of it. You cannot simply cut spending. It is going to take a group of things that has to happen. And I think that we need to put together a group of experts who can recommend to us what groups of things need to happen in order to make sure that our entitlement programs can survive.

You mentioned the health care sector. As deep a trouble as it is, that is new information and I appreciate you bringing that to our attention this morning.

One of the things that we struggle with, obviously, is what is the proper level of taxes in order to get the economy to grow? Obviously you cannot tax 100 percent of production or you are not going to get any revenues because nobody is going to produce. Similarily, you cannot have zero taxes because you will not have any revenue.

But somewhere in between there is a magic level. And that will vary, depending on tax levels and what kind of taxes you are talking about. I think this is part of your discussion on tax reform.

What tax reform do you think might be easiest to manage by the Congress? Answer that question first and then I will bring up another one.

General WALKER. First, I think you have several issues. One, how much of the economy do taxes represent? You are correct in saying you want to keep that as low as possible in order to maximize economic growth, maximize disposable income, and maintain our competitive advantage compared to Europe.

Then you have to decide how are you going to go about raising that revenue? And then you get into how much are you going to rely on individuals? How much are you going to rely on corporations? How much are you going to rely on income taxes? How much are you going to rely on payroll taxes? How much are you going to rely on consumption taxes or other excise taxes? And then how are you going to allocate the burden within those groups? How progressive is it going to be, et cetera.

A few preliminary thoughts. We want to maintain a competitive advantage as compared to Europe. We want to minimize tax burdens while dealing with our fiscal imbalance. So that means we are going to need more revenues.

Corporations do not have duties of loyalty to countries. They have duties of loyalty to their shareholders. You must be competitive in your tax structure vis-a-vis corporations because they have the ability and an incentive to do business elsewhere if you do not.

As to individuals: obviously, you want to be fair and equitable with regard to the tax burdens there. But most Americans are not looking to be citizens of someplace else. Most other citizens are looking to be citizens of America. We have to keep that in mind.

I think that our tax system today is so mind numbingly complex it is virtually impossible for persons in good faith who itemize to do their taxes and know they have done it corretly. Many Americans pay more in payroll taxes than they do income taxes. That is a fact. And yet we are using some of the payroll taxes to pay operating expenses of the Government. We have to keep that in mind.

I think we need to do several things. We need to broaden the tax base, reduce and eliminate a number of tax preferences to keep rates as low as possible to be able to help assure equity, consistency, and economic efficiency. We are also going to need to consider some type of a consumption tax that may or may not be dedicated because income and wealth in this country is distributed fundamentally differently today than it was in the early 1900's, when income taxes came into effect.

The $345 billion tax gap would be a good place to start—with more information returns, more withholding, more targeted IRS enforcement. But you are not going to solve the tax gap until you do comprehensive tax reform with simplification.

Lastly on simplication, I have paid AMT several times now. I think that is a massive bait and switch surtax. I think you would be much better off to build it into the rates and just be honest with people. If you want to have a surtax on the really wealthy, then have a surtax on the really wealthy. But the idea of AMT, where you in good faith fill out your tax return and think you are done and then all of a sudden you have to go do this other one—all it is is a surtax. You would be better have a streamlined and simplified income tax that builds it into the rates. And then if you want to have a surtax, target it.

Those are a few thoughts.

Senator ALLARD. Mr. Chairman, my time is run over but for the committee's benefit I would like to ask for a clarification, if I may have the time.

Senator CONRAD. Sure.

Senator ALLARD. You talked about consumption tax. I have read tax policy experts who will say that a flat tax and a sales tax are both consumptive taxes, depending on how they are structured. So when you talk about a consumption tax, which one are you referring to?

General WALKER. It depends on how they are structured. You could have an income tax that does not tax savings and does not tax certain items that do not represent consumption and pretty much get a consumption-based tax, if you will. So there is different ways you can get there.

The last thing that I would mention, let me give you one example of something that really needs to be on the table. The single largest tax preference in the budget or probably in the Government today is the fact that no American, no matter how much money they make, no matter how wealthy they are, pays a dime of income or payroll taxes on the value of employer-provided and paid health care, even if they have a very lucrative health care package. That is approaching $200 billion a year.

And it is part of the problem with health care cost explosion because it disassociates people from the cost of health care. And that is something that the Mack-Breaux Commission put on the table.

The good news is there is lots of good work that has been done on entitlement reform and taxes. You do not have to reinvent the wheel. You can pull from work that has already been done and come up with something that hopefully addresses the elements we talked about.

Senator ALLARD. Thank you, Mr. Chairman.

Senator CONRAD. I thank the Senator from Colorado for his good questioning.

Senator CARDIN. Again, Senator Cardin, you were not here when I welcomed the new members to this committee. We are delighted that you and Senator Whitehouse are here. Senator Sanders was here earlier.

We very much appreciate your coming and replacing a former No. 2 person on our side on this committee, Senator Sarbanes, who was an essentially valuable member of this committee. We anticipate that you will make significant contributions here, as well.

Senator CARDIN. Mr. Chairman, I thank you very much for these comments. Serving in the other body, I served on only one committee so it was very much expected I would make those hearings. In this body they put me on a lot of committees.

So I apologize for the fact that Secretary Rice is before the Foreign Relations Committee and that has divided my time today.

I want to thank you very much for holding this hearing. I had a chance to work with you, Mr. Walker, when I was in the House, and I always found your information to be extremely helpful, particularly your projections regarding areas that we need to address.

Today we are talking about the long-term budget outlook. Let me just caution you, as you were talking about the Alternative Minimum Tax—and I agree with you on AMT. Remember, we got the AMT because Congress wanted to simplify, broaden, and reduce rates.

So let us be careful as to how we move forward because our actions may very well not produce the results that we anticipate. Our tax code is the most complicated it has ever been and we have gone through I do not know how many tax simplifications. So we should be very cautious about that.

The other point I want to make is that as we look at ways of solving the budget dilemma that we are in, and I know that Congress will examine entitlement spending, let us remember that it was not too many years ago that the projections for our budget were pretty good.

I remember some of the documents that you prepared for the Ways and Means Committee as to how we got this reversal, particularly your analysis of the 2001 and 2003 tax cuts and the effect our budget situation if those provisions are made permanent.

You already mentioned earlier the impact of the medicare prescription drug law has.

As we look for ways of dealing with our budget problems today, let us be mindful of how we got here so that we do not repeat the mistakes we have made in the past.

Medicare and Medicaid are clearly a challenge for the Federal budget. There is no question about that. I do not how we deal with that if we address the overall issue of health care in this country. How do you get a handle on the Federal Government's costs health care unless you address the lack of affordable health insurance, the rising cost of long-term care, and as you point out, a more responsible approach to Medicare prescription drug coverage?

I do not know whether you have done any projections in this or not, or whether you have any views on that, but it seems to me that we will not benefit taxpayers or consumers if we just attempt attempt to rein in Medicare and Medicaid but do little about the entire health care system itself.

General WALKER. My personal view is, Senator, that while there are a number of things that we can and should do in the short term to try to moderate health care costs, including moving to national practice standards,—something that would help to reduce costs, improve quality, and reduce litigation risk, among other things,—that ultimately we are going to have to engage in comprehensive health care reform in installments. Medicaid is really not just health care. It is also long-term care. About two-thirds of Medicaid now is long-term care. That is really a hybrid. It is really life maintenance. It is really not health care.

So I think that ultimately we are going to have to engage in much broader reforms, but we are going to have to do it in installments. We are also going to have to do something about our savings rate. And I would respectfully suggest for your consideration one of the things that we might want to think about for Social Security is to reform Social Security to make it solvent, sustainable and secure indefinitely, keeping it as a defined benefit program for a variety of reasons and adding a supplemental individual account on top with mandatory personal savings through payroll deduction—money put into a real trust fund with real investments, with real fiduciary responsibilities where people go to jail if they violate that responsibility.

I think that combination could help us not just with Social Security, but also with long-term care; it could help us with our savings rate; it could help us with a number of things. And I think that could be done in a way that would be broadly supported.

Senator CARDIN. Some of us have looked at that option for Social Security and support trying to provide supplemental accounts. The difficulty, of course, is that there is a budget score associated with these accouonts.

General WALKER. Actually, you can because what I am talking about is you reform Social Security—and we can talk about that if you want, how to do that—to where you make it solvent, sustainable and secure. And then you have individuals, through payroll deduction, have 2 percent of their pay go into an individual account. It is their money, not our money. It is not a budget item.

Senator CARDIN. But if you take it out of the Social Security system, you are compounding—

General WALKER. I am not taking it out. It is not a carve-out. But Congress is probably poised to increase the minimum wage.

Senator CARDIN. I think it is an intriguing suggestion, but as you pointed out, payroll taxes are rather oppressive already for a large number of Americans.

General WALKER. It is. It is a regressive tax and I think one needs to be concerned with that. But here is the difference, this is not a tax increase. This is your money.

The other thing is this would provide for a very substantial pre-retirement death benefit that one does not get in Social Security today, et cetera, et cetera.

Senator CARDIN. I want to continue this, Mr. Chairman, but this is not the right time. I would just urge that for lower-wage workers, supplemental accounts are not feasible unless someone puts money on the table in addition to the worker. But we can debate that issue at a different point.

Thank you, Mr. Chairman.

Senator CONRAD. Let me just say I, for one, I like this basic construct. I think it has to be part of an overall tax reform plan because we are using payroll taxes to fund operating expenses. If you were doing this in the private sector, if you were taking retirement funds of employees, and using it to pay operating expenses, you would be on your way to a Federal institution. It would not be Congress, it would not be the White House. You would be headed for the big house. That is a violation of Federal law.

We have just an incredible mismatch here in terms of our funding mechanisms and the outgo.

I would like to go for just a minute back to the health care issue because that really is the 800 pound gorilla, and that is what has the potential to swamp the boat around here unless we address it. And I agreed you entirely. I do not think we can solve this in one fell swoop. I think it is going to take a series of bite-sized chunks over time. Frankly, I do not think we know enough at this moment to solve the long-term problem of Medicare. But we have to make progress.

One thing I have talked about repeatedly on this committee is the fact that about 5 percent of Medicare beneficiaries use half of the money. It is not quite that, is about 6 percent use half of the money currently. But it has been in that range, 5 percent or 6 percent use half the money. Now my business school training says you focus like a laser on that kind of fact.

Can you help us understand, we know that these are the chronically ill, people with multiple conditions. Have you had a chance to study this? And have you had any sense of how we might make progress with respect to that population?

General WALKER. Clearly, there is an opportunity to use more case management approaches, which is what you are talking about. A very high percentage of the cost for Medicare relates to a fairly small percentage of those that are covered by Medicare. And in the private sector typically, and even frankly in the public sector with regard to some governments, you typically have a much more aggressive case management which is not just to control cost but it is also to try to assure quality. For examplel, if you are taking too many prescriptions that can actually be a detriment, for example, to the individual involved.

I think clearly that is an area that needs to be explored as well as, as I said, national practice standards for medical standards, as well as a few other areas.

But one of the things you have to keep in mind under our current health care system, the incentives are for everybody to do more, more, and more. Why? Because providers get paid more, because they reduce their litigation risk, and because individuals are not paying for it.

So the current incentives under our system are, whether it is technology, whether it is drugs, or whether it is procedures, is to do more, more, more. One of the things we are all going to have to come to grips with is there is a difference between whether or not people ought to have opportunity to gain access to every technology procedure and drug that exists versus whether the taxpayers ought to pay for it. Because the fact is that if there is one thing that could swamp the ship of state and bankrupt America, it is health care. There are lots of ways you can get there but one of the ways that forces you to get there is to have a budget for health care.

I mean, there are a number of procedures that could be done that do not meaningfully improve or extend life but they cost a tremendous amount of money. And it is reality. It is tough but it is reality.

Senator CONRAD. Senator Gregg, any final comments?

Chairman GREGG. I want to followup on that, but I had another issue I wanted to followup on, too. But let me followup on that. This concept of a separate budget for health care might make a lot of sense since it is such a large percentage of our budget.

I have been thinking about how do you address this? How do you address this health care issue? Obviously everyone is thinking about it.

But your point earlier that because health insurance premiums are fully deductible and health insurance is therefore subsidized dramatically by our tax laws, then that creates this disincentive for market forces to play a role and creates, in many instances, overutilization and costs which should not have to occur.

I have always thought that a better health care system might be one where we absolutely make sure that everybody is insured for a catastrophic event. So nobody has to fear being wiped out because they discover they have cancer in their family or they have a serious accident that harms them, so that every American knows that they are not going to lose their home or their life savings as a result of a catastrophic event. And then you allow the marketplace and individuals, with obviously some support for lower income people, to decide what percentage they are going to want to personally cover of the difference through insurance.

And you could pay for that, it would seem to me, by first allowing the market to create the catastrophic insurance but subsidize that by basically limiting the amount of deductibility for health insurance to a number that is reasonable so that gold plated plans are no longer fully deductible at the corporate level. Does that make any sense to you?

General WALKER. Let me take that, elements of it, I think, do make a lot of sense.

First, as you know Senator, it is not a deduction on health care that I am talking about. It is the exclusion.

Chairman GREGG. Yes, I mean it does not—

General WALKER. But it is bigger that way.

Chairman GREGG. Of course it is.

General WALKER. The reason it is bigger that way is because you do not pay payroll taxes on it either. You can get a deduction for your income tax but you do not get a deduction from the taxable wage base. But with an exclusion you get both. It is not included in the taxable wage base for Social Security and Medicare nor is it in the income tax.

I think you are on to the right path. My personal view is that if you look long-term that if we were somehow to move to a system that assured every American that they had certain basic and essential health care services, and I would suggest that might include catastrophic, definitely protection against financial ruin due to unexpected catastrophic illness. Now catastrophic is different if you are Bill Gates or one of us.

But I think you also have to think about wellness and inoculations. Those are things I think you have to think about. And I think then to create options for people to get more than that if they want, but they have to decide how much of their resources do they want to allocate off for that.

And one of the things we have to do, we have to do more to help individuals assume more personal responsibility for their own health. Right now, even for Federal programs, if you have very poor health habits you do not pay a different premium. So people who are behaving properly with regard to smoking, eating, drinking, whatever, they are subsidizing people who are not. And I think we need to do more to figure out how we encourage people to assume more personal responsibility for their own health because we have a number of very negative leading indicators on health.

For example, we are No. 1 in the world in obesity. Nobody is even close. And that is a pre-indicator for heart disease and diabetes. And we need to start doing something about it. But part of that has to do with the individual. The individual has to assume more responsibility.

Chairman GREGG. Thank you for that.

I was pointing out to my colleague that the obesity issue is more a function of the subsidized agricultural industry than anything else.

[Laughter.]

General WALKER. We can get into that in a different hearing if you want.

Senator CONRAD. You will not be invited to that hearing.

[Laughter.]

Chairman GREGG. You used the term mandatory reconsideration trigger. What did you mean by that?

General WALKER. What I mean by that is that when a certain mandatory programs, take Medicare, Medicaid, whatever, reaches a certain size of the Federal budget and/or the economy, that it forces reconsideration.

Now something like that was put in the prescription drug bill. The alarm is supposed to go off this year to say that by 2012 you are going to hit that trigger point. But that is only Medicare. Time will tell what is done with that alarm, when that alarm goes off. But you need to think about other segments of the budget—both the spending side and tax preferences—

Chairman GREGG. Have you looked at my SOS bill, which has that?

General WALKER. I have not, but I will.

Senator CONRAD. Mr. Walker, I was at an event last week with former President Clinton and he was very focused on this health care issue. One of the things that he said in his remarks was that we are now of 16 percent of GDP on health care. The next highest country in the world is 11 percent. And that Delta, that difference between 11 percent and 16 percent of GDP amounts to $800 billion a year in terms of health care expenditure in this country.

The second thing he mentioned, and I hesitate to quote him because I am just remembering this from his description and so I may have misheard. But he had an extraordinarily high figure of over 30 percent on the administrative costs of health care in this country.

Have you looked at that issue?

General WALKER. I have heard 20 to 30 percent. I can take a look at it when I get back. It is very high, there is no question.

Senator CONRAD. That seems to me, if we were analyzing this like in business, these outliers where you have 5 percent using half of the money, where you have an administrative cost that is much, much higher than you would see in almost every other economic segment, those are places it seems to me we have to focus like a laser. I would be very interested in any analysis you can provide the committee with respect to this administrative cost issue, any additional information you could provide the committee with respect to the 5 percent of Medicare beneficiaries who use half of the money, any proposals that you would have for how we address that to both save money and, I believe, improve health care outcomes. **(See additional information)**

I would also be interested in your national practice standards and any proposal that you would have there because we now know that there are vast disparities across the country in how much money is being allocated to various health care problems without differences in health care outcomes. **(See additional information)**

In other words, I have seen studies in the last 10 days that show a 500 percent difference in cost to deal with various health care conditions, one part of the country to another, with virtually no difference in the quality of outcomes. That is another thing that ought to jump out at us.

If you could provide that. **(See additional information)**

Senator Whitehouse, if you have an additional question or thought?

Senator WHITEHOUSE. Mr. Chairman, I was hoping that I could add to Mr. Walker's homework with an additional request along the lines of the things that you have so wisely asked about. And that would be for you to take a look at the information infrastructure in health care.

The Economist magazine reported not long ago that the adoption of information technology in the health care industry is the second worst of any American industry, lagging only behind the mining industry. The RAND Corporation has indicated that with adequate investment in information technology in the health care sector, we could save as much as $162 billion, with a B, per year.

Those are public reports and public information. I would love to have those added to the list for review by your organization if the Chairman would permit me to add to his list. **(See additional information)**

Senator CONRAD. I certainly would. I think it is an excellent question. General Walker.

General WALKER. If I can, first, there are actually a few areas where Government leads by example other than GAO. VA is one.

VA probably has the best technology for medical records in the country. And we need to learn from that.

You are correct, national practice standards could help reduce costs, improve consistency and enhance quality.

Last thing, I want to come back to something that is relevant to this discussion that Senator Allard mentioned before. This country directly spends $2.5 trillion to $3 trillion per year. It issues tax preferences equal to $700 billion to $800 billion a year in foregone revenue. And that is backdoor spending. That is what tax preferences are. They both affect the bottom line.

But for the most part, we do not really know whether the spending programs are effective and whether the tax policies are effective. I think one of the things that we sorely need in order to be able to make intelligent decisions to help reengineer not just spending policy but tax policy is a set of key national indicators, outcome-based indicators—economic, safety, security, social, environmental—that will help us to answer three questions: Where are we today? How are we trending? And how do we compare with others?

Senator Allard is correct to say that there are differing degrees of reliability of data. But we need to seek to work to develop these. Some countries have them. Others do not. We are working with the National Academy of Sciences to try to make this a reality, as well as with the OECD.

Frankly, I think it is a great opportunity for a public/private partnership because if Congress had this data it could make a lot more informed judgments in the executive branch about where we should and should not be spending and where we should and should not be issuing tax preferences. I think it is something that needs to be on the radar screen.

Senator CONRAD. One final thought, and I like that idea very much. We would hope that as you develop these that you would let this committee know, because I think there would be strong interest here in this notion of national indicators. **(See additional information)**

One of the things I have always thought we should do is have a periodic review of programs to see how much money is actually being delivered to where it is intended. One of the things that has really concerned me is in the few times I have had a chance to look at a program, it may have started a very well intended way, it may have worked well at the beginning, but over time hasten ossified and calcified and is not delivering the benefits to where they are intended at all, or not at least even a majority of the benefits. Instead, it is getting caught up in some kind of administrative stream.

Do you do a review of major programs to see how much of what goes in actually comes out the other side for the purposes intended?

General WALKER. To my knowledge we have not but it is a good idea. Obviously, as you know, the executive branch has something called the Program Assessment Rating Tool, which is supposed to help assess the effectiveness of certain programs. Unfortunately, that is just spending programs, it is not tax policies. But I am not sure that this is even part of that effort.

Clearly, it is similar to what you said before about overhead costs for health care. We need to understand how much money is actually going to the targeted players. And there is little doubt in my mind that we have way too much overhead. I mean, think about it.

Senator CONRAD. Way too much overhead.

General WALKER. Think about this for a second. I have sent up to you and every member of the Senate our 21st Century Challenges document, Re-Examining the Base of the Federal Government.

Just look at how the Government is organized. We have over 10 regions. We have all of these different grade levels. That is based on the 1950's. It is based on technology and transportation systems and management models of the 1950's and we are still trying to operate that way.

Take the Pentagon. If it was 20 percent smaller, it could probably be 50 percent more productive. For example it takes over 20 units to sign off on activating and deploying 10 reservists or more. There is tremendous opportunity to delayer, de-silo, and streamline Government.

Senator CONRAD. And it will never happen unless we have the information.

We would like to talk to you further about this matter because I really do think we have to find a way to bring this to the attention of our colleagues. And it will never happen unless we set up some kind of structure to periodically review.

I tell you, I am appalled by what I am seeing in terms of administrative overhead. These agencies take a cutoff the top before the money ever gets delivered for the purpose intended. It is not unusual for this to be 20 percent. Now there is no excuse for administrative overhead to be of that magnitude.

So I would very much like to have a discussion with you about how we set up an ongoing program to review the administrative overhead that is on these programs.

With that, I want to again thank you so much for being here today. And thanks once again, Chairman Gregg, for his many courtesies that have been extended to our side of the aisle during his chairmanship.

[Whereupon, at 12:19 p.m., the hearing was adjourned.]

ADDITONAL INFORMATION FROM GENERAL WALKER

Information Provided in Response to Requests for Additional Information by Chairman Conrad and Senator Whitehouse.

Health System Administrative Costs
While GAO has not conducted a study of overall health system administrative costs, a 2001 GAO report analyzed existing data among private insurers. In this report, GAO found that, "overall, insurers' administration costs and expenses, other than benefits, typically account for about 20 percent to 25 percent of small employers' premiums compared to about 10 percent of large employers' premiums. These expenses can range from around 5 percent to 30 percent of the premium dollar, depending on the size of the employer, type of plan, and insurer." (*Private Health Insurance; Small Employers Continue to Face Challenges in Providing Coverage,* **GAO-02-8**)

Distribution of Medicare Costs Among Beneficiaries
As indicated in the Henry J. Kaiser Family Foundation's Medicare Chartbook (3rd Ed., Summer 2005, pp. 52, 56), "Medicare spending is highly concentrated among a minority of beneficiaries. In 2002, 7 percent of beneficiaries incurred expenditures of $25,000 or more, accounting for just over half of program spending. Twelve percent of beneficiaries accounted for more than two-thirds of program spending."

National Practice Standards
At a forum sponsored by GAO in January 2004 on Health Care, experts with a variety of backgrounds discussed strategies for controlling costs and enhancing value in health care. The group determined that effective evidence-based medicine required authoritative standards of practice. Such standards would guide clinical decision-making and payers' determination about whether services claimed were medically necessary. They may also help address the problem of wide variability observed in medical practices in the United States. (Comptroller General's Forum entitled *Health Care: Unsustainable Trends Necessitate Comprehensive and Fundamental Reforms to Control Spending and Improve Value*, GAO-04-793SP).

Health information technology (IT) provides a promising solution to help improve patient safety, reduce inefficiencies, improve the quality of care, bolster the preparedness of our public health infrastructure, and save money on administrative costs. We reported in 2003 that technologies such as electronic health records and bar coding of certain human drug and biological product labels have been shown to save money and reduce medical errors.[1] Health care organizations reported that IT contributed other benefits, such as shorter hospital stays, faster communication of test results, improved management of chronic diseases, and improved accuracy in capturing charges associated with diagnostic and procedure codes. Even with these reported benefits, however, our work in 2003 also highlighted the lack of an overall IT strategy to support federal agencies' abilities to respond to public health emergencies. Accordingly, we recommended that HHS develop an IT strategy to support public health emergency response that sets priorities for IT initiatives and coordinates the development of IT standards for the health care industry.[2] Subsequently, in July 2004, we testified on the benefits that effective implementation of IT can bring to the health care industry and the need for HHS to provide continued leadership, clear direction, and mechanisms to monitor progress in order to bring about measurable improvements.[3]

Recognizing the potential for the effective implementation of health IT to prevent medical errors, reduce costs, improve quality, and produce greater value for health care expenditures, in April 2004 President Bush called for the widespread adoption of interoperable electronic health records within 10 years and issued an executive order that established the position of the National Coordinator for Health Information Technology within the Department of Health and Human Services (HHS). The National Coordinator was designated to be the government official responsible for the development and execution of a strategic plan to guide the nationwide implementation of interoperable health IT in both the public and private sectors.[4] In July 2004, the Secretary of HHS and the National Coordinator released a framework for strategic action that described goals for achieving nationwide interoperability of health IT and actions to be taken by both the public

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[1]GAO, *Information Technology: Benefits Realized for Selected Health Care Functions*, GAO-04-224 (Washington, D.C.: Oct. 31, 2003). [ATL170607, p.10 R2 –OK, EJS, 1/29/07]

[2]GAO, *Bioterrorism: Information Technology Strategy Could Strengthen Federal Agencies' Abilities to Respond to Public Health Emergencies*, GAO-03-139 (Washington, D.C.: May 30, 2003). [ATL170651, p.1 R1-R3 and p.7 R1 & R2 – Ok, EJS, 1/29/07]

[3]GAO, *Health Care: National Strategy Needed to Accelerate the Implementation of Information Technology*, GAO-04-947T (Washington, D.C.: July 14, 2004). [ATL170607, p.12 R4 – OK, EJS, 1/29/07]

[4]Executive Order 13335, *Incentives for the Use of Health Information Technology and Establishing the Position of the National Health Information Technology Coordinator* (Washington, D.C.: Apr. 27, 2004). [ATL170607, p.6 R3 – OK, EJS, 1/29/07]

and private sectors in implementing a strategy.[5] Since then, we have reported or testified on several occasions on HHS's efforts to define its national strategy for health IT and to meet the goals defined in its framework.[6] We recognized that HHS has taken steps through various initiatives to develop and implement a national strategy and has continued to move forward with its mission to guide the nationwide implementation of interoperable health IT in the public and private health care sectors. However, we found that HHS lacked the detailed plans and milestones needed to implement and integrate the various initiatives intended to support the implementation of its national strategy. Therefore, we recommended that HHS develop detailed plans and milestones for implementing its strategy and to ensure that its goals are met. HHS agreed with our recommendation and has taken some steps to develop detailed plans, including further refinement of the goals, objectives, and strategies described in its framework.[7]

[5]Department of Health and Human Services, "*The Decade of Health Information Technology: Delivering Consumer-centric and Information-rich Health Care: A Framework for Strategic Action*" (Washington, D.C.: July 21, 2004). [ATL170607, p.7 R5 – OK, EJS, 1/29/07]

[6]GAO, *Health Information Technology: HHS Is Taking Steps to Develop a National Strategy*, GAO-05-628 (Washington, D.C.: May 27, 2005); GAO, *Health Information Technology: HHS Is Continuing Efforts to Define a National Strategy*, GAO-06-346T (Washington, D.C.: Mar. 15, 2006); GAO-06-1071T. [ATL170607, p.12 R2 & R6 – OK, EJS, 1/29/07]

[7]GAO, *Health Information Technology: HHS Is Continuing Efforts to Define Its National Strategy*, GAO-06-1071T (Washington, D.C.: Sept. 1, 2006). [ATL170607, p.12 R5 – OK, EJS, 1/29/07]

Information on Key National Indicators Provided

The Key National Indicators Initiative (KNII) emerged after GAO—in cooperation with the National Academies—convened a forum in February 2003. At this forum, a cross-section of public and private sector leaders provided their views on whether and how to develop such a national system and believed that it was an important idea that should be explored further.[1] Participants at the GAO forum suggested that any effort to create a comprehensive indicator system in the U.S. should build on lessons learned from other efforts both around the country and worldwide. In November 2004, GAO published a report which looked at the current state of the practice of developing comprehensive key indicator systems—by studying the indicator systems of various jurisdictions across the U.S. as well as those of several other countries and supranational organizations—and identified design features and organizational options that could help inform the development of such a system in the United States.[2] GAO has also studied topical indicators, such as environmental indicators, within the U.S.[3]

Development of key national indicators to measure progress toward national outcomes, assess conditions and trends, and help communicate complex issues is one tool to help deal with the new and more complex challenges that face the U.S. in the future. Some other countries have key national indicator systems, but not the United States.

In the Oversight letter I sent to Congress in November 2006, I suggested that Congressional interest and attention would be critical to the successful development of a comprehensive national indicator system. The Key National Indicators Initiative, under the auspices of the National Academies, has begun efforts to develop such a system which could be used to inform strategic planning, enhance performance and accountability reporting, inform congressional oversight and decision making, facilitate

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[1] GAO, *Forum on Key National Indicators: Assessing the Nation's Position and Progress*, GAO-03-672SP (Washington, D.C.: May 2003).
[2] GAO, *Informing Our Nation: Improving How to Understand and Assess the USA's Position and Progress*, GAO-05-1 (Washington, D.C.: Nov. 10, 2004).
[3] For example, GAO, *Environmental Indicators: Better Coordination Is Needed to Develop Environmental Indicator Sets that Inform Decisions*, GAO-05-52 (Washington, D.C.: Nov. 17, 2004) and *Environmental Information: Status of Federal Data Programs that Support Ecological Indicators*, GAO-05-376 (Washington, D.C.: Sep. 2, 2005).

oversight, and stimulate greater citizen engagement. GAO's work has pointed to the need for a governmentwide strategic plan, supported by key national indicators to assess performance, position, and progress. A governmentwide strategic plan could provide an additional tool for re-examining existing programs and proposing new programs. GAO has also called for a governmentwide performance report linked to key indicators to articulate the government's accomplishments.

PREPARED STATEMENT AND QUESTIONS FROM SENATOR GRASSLEY

Chuck Grassley

Statement and Questions of Senator Charles E. Grassley
Budget Committee Hearing on Long-Term Budget Outlook
January 11, 2007

General Walker, we all know that the tax gap is not a new issue. Michael Brostek from your office testified before a subcommittee hearing in the Finance Committee that the voluntary compliance rate has ranged from around 81 percent to 84 percent over the past three decades. In the Finance Committee, we take the tax gap very seriously, because it's not fair to the vast majority of taxpayers that pay their taxes on time. We have had several hearings to examine the size, sources, and solutions to the tax gap, and we have enacted several steps to reduce the tax gap, such as boosting the IRS' whistleblower program and authorizing the private debt collection program. But we need to do more. Dozens of factors contribute to the tax gap and dozens of solutions are needed to close it. I am completely in support of taking appropriate measures to close the tax gap – and I will work aggressively towards enacting legislative changes to help close it - but it has to be done in an effective manner. I don't think that there is any easy solution.

There seems to be a general consensus that potential solutions to the tax gap fall into three categories: (1) Additional and more efficient enforcement by the IRS; (2) Additional enforcement tools for the IRS, such as information reporting and withholding; and (3) changes to our tax base that reduce the complexity of our current system, including reforming or eliminating some tax expenditures, as recommended by the staff of the Joint Committee on Taxation in a report called "Options to Improve Tax Compliance and Reform Tax Expenditures". I would note that some of the JCT staff's recommendations have been enacted, but there are many other proposals in that report that have not been enacted, such as repealing the deduction for interest on home equity loans, modifying the social security tax and self-employment tax rules, and moving to a territorial system for foreign business income. Others have suggested even more fundamental reform, like shifting to a consumption tax. Many of these changes, of course, would create winners and losers, making them controversial.

Do you agree that IRS enforcement, information reporting or withholding, and changes to the tax base are the three general categories of tax gap solutions, and how much tax gap reduction do you think is achievable in each of these categories?

Last year, Commissioner Everson testified before this committee that the tax gap could be reduced by $50 to $100 billion without changing the way the Government interacts with taxpayers. That's quite a bit, but it's only a quarter to a third of the tax gap, as calculated by the IRS. So I find it hard to believe that going after the bulk of the tax gap with IRS enforcement would not result in a much more intrusive IRS. In your view, how would the IRS have to change its enforcement practices to actually close the tax gap, how much more intrusive would the IRS be in the lives of taxpayers, and what kind of time frame should Congress expect for the resulting revenues to come in to the Treasury?

As we examine proposals for new reporting and withholding requirements, such as basis reporting for securities transactions, what additional types of income should we consider subjecting to withholding or reporting, and what factors should be considered in evaluating such proposals.

In your view, what role should tax reform and simplification play in reducing the tax gap, and what factors should Congress consider in evaluating these types of proposals as a way to reduce the tax gap?

ANSWERS TO QUESTIONS SUBMITTED

Questions for the Record from Senator Grassley
Senate Budget Committee Hearing on Long-Term Budget Outlook
January 11, 2007

General Walker, we all know that the tax gap is not a new issue. Michael Brostek from your office testified before a subcommittee hearing in the Finance Committee that the voluntary compliance rate has ranged from around 81 percent to 84 percent over the past three decades. In the Finance Committee, we take the tax gap very seriously, because it's not fair to the vast majority of taxpayers that pay their taxes on time. We have had several hearings to examine the size, sources, and solutions to the tax gap, and we have enacted several steps to reduce the tax gap, such as boosting the IRS' whistleblower program and authorizing the private debt collection program. But we need to do more. Dozens of factors contribute to the tax gap and dozens of solutions are needed to close it. I am completely in support of taking appropriate measures to close the tax gap—and I will work aggressively towards enacting legislative changes to help close it—but it has to be done in an effective manner. I don't think that there is any easy solution.

There seems to be a general consensus that potential solutions to the tax gap fall into three categories: (1) Additional and more efficient enforcement by the IRS; (2) Additional enforcement tools for the IRS, such as information reporting and withholding; and (3) changes to our tax base that reduce the complexity of our current system, including reforming or eliminating some tax expenditures, as recommended by the staff of the Joint Committee on Taxation in a report called "Options to Improve Tax Compliance and Reform Tax Expenditures." I would note that some of the JCT staff's recommendations have been enacted, but there are many other proposals in that report that have not been enacted, such as repealing the deduction for interest on home equity loans, modifying the social security tax and self-employment tax rules, and moving to a territorial system for foreign business income. Others have suggested even more fundamental reform, like shifting to a consumption tax. Many of these changes, of course, would create winners and losers, making them controversial. I have four questions for you General Walker, and I'd like to ask them all first, then have you answer each of them.

1) **Do you agree that IRS enforcement, information reporting or withholding, and changes to the tax base are the three general categories of tax gap solutions, and how much tax gap reduction is achievable in each of these categories?**

   Devoting additional resources to IRS enforcement; providing IRS with more enforcement tools, such as information reporting and withholding; and simplifying or fundamentally reforming the tax code are three general approaches we believe would contribute to reducing the tax gap in the following ways:

- Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities.

- Providing IRS with more enforcement tools, particularly additional withholding and information reporting, also has the potential to reduce the tax gap by billions of dollars, especially if those tools help IRS deal with the largest contributor to the tax gap—underreported income. However, designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, there are varied forms of underreporting, and the requirements could impose costs and burdens on third parties.

- Tax law simplification and reform both have great potential to reduce the tax gap by billions of dollars. The extent to which the tax gap would be reduced depends on which parts of the tax system would be simplified and in what manner as well as how any reform of the tax system is designed and implemented. Further, changes in the tax laws and system to improve tax compliance could have unintended effects on other tax system objectives, such as those involving economic behavior or equity.

Multiple options to reduce the tax gap exist within each of these approaches, and using multiple approaches may be the most effective strategy to reduce the tax gap, since no one approach is likely to address noncompliance fully and cost effectively. While we can and should take steps to reduce the tax gap, it is unrealistic to expect that we will ever eliminate it.

Although these three approaches have promise to reduce the tax gap, providing quality services to taxpayers is an important part of any approach to improve compliance and thereby reduce the tax gap. For example, if the forms and instructions taxpayers use to prepare their taxes are unclear, taxpayers may be confused and make unintentional errors. IRS's taxpayer service efforts include education and outreach programs and simplifying the tax process, such as by revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. Improving taxpayer service would also be a key consideration in implementing the three approaches summarized above. For example, expanding enforcement efforts would result in increased interactions with taxpayers, requiring improved processes to more efficiently communicate with taxpayers. Also, changing tax laws and regulations would require educating taxpayers of the new requirements in a clear, timely, and accessible manner.

2) Last year, Commissioner Everson testified before this committee that the tax gap could be reduced by $50 to $100 billion without changing the way the Government interacts with taxpayers. That's quite a bit, but it's only a quarter to a third of the tax gap, as calculated by the IRS. So I find it hard to believe that going after the bulk of the tax gap with IRS enforcement would not result in a much more intrusive IRS. In your view, how would the IRS have to change its enforcement practices to actually close the tax gap, how much more intrusive would the IRS be in the lives of taxpayers, and what kind of time frame should Congress expect for the resulting revenues to come in to the Treasury?

Reducing the tax gap is an important goal, as when taxpayers do not pay all of their taxes, honest taxpayers carry a greater burden to fund government programs and the nation is less able to address its long-term fiscal challenges. However closing the entire tax gap through enforcement is neither feasible nor desirable because of costs and intrusiveness.

Devoting additional resources to enforcement would help IRS contact and assess additional taxes for millions of taxpayers it believes to be potentially noncompliant but cannot otherwise contact because of resource constraints. However, it is unlikely that IRS would be able to close the tax gap strictly through these additional contacts. In 2002, IRS estimated that a $2.2 billion funding increase would allow it to take enforcement actions against the potentially noncompliant taxpayers it identifies but cannot contact and would yield an estimated $30 billion in revenue. Expanded enforcement efforts could also have an indirect effect through increases in voluntary tax compliance, although the precise magnitude of the indirect effects of enforcement is not known with a high level of confidence. In order to further reduce the tax gap, it is likely that additional strategies would need to be employed such as expanding information reporting or withholding and tax simplification and reform, as previously described.

Reductions in the tax gap that could be derived from additional enforcement action may not be immediate. The reductions may occur gradually as IRS is able to hire and train enforcement personnel. For example, for a recent compliance initiative, IRS forecasted that in the initial year after expanding enforcement activities, the additional revenue it expects to collect is less than half the amount it expects to collect annually in later years.

3) As we examine proposals for new reporting and withholding requirements, such as basis reporting for securities transactions, what additional types of income should we consider subjecting to withholding or reporting, and what factors should be considered in evaluating such proposals?

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:

- Require more data on information returns dealing with capital gains income from securities sales. Recently, we reported that an estimated 36 percent of taxpayers misreported their capital gains or losses from the sale of securities, such as corporate stocks and mutual funds. Further, around half of the taxpayers who misreported did so because they failed to report the securities' cost, or basis, sometimes because they did not know the securities' basis or failed to take certain events into account that required them to adjust the basis of their securities. When taxpayers sell securities like stock and mutual funds through brokers, the brokers are required to report information on the sale, including the amount of gross proceeds the taxpayer received; however, brokers are not required to report basis information for the sale of these securities. We found that requiring brokers to report basis information for securities sales could improve taxpayers' compliance in reporting their securities gains and losses and help IRS identify noncompliant taxpayers. However, we were unable to estimate the extent to which a basis reporting requirement would reduce the capital gains tax gap because of limitations with the compliance data on capital gains and because neither IRS nor we know the portion of the capital gains tax gap attributed to securities sales.

- Requiring tax withholding and more or better information return reporting on payments made to independent contractors. Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. We have also identified other options for improving information reporting for independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to report separately on their tax returns the total amount of payments to independent contractors. IRS's Taxpayer Advocate Service recently recommended allowing independent contractors to enter into voluntary withholding agreements.

- Requiring information return reporting on payments made to corporations. Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997, payments made by others to corporations are generally not covered by information returns. The Taxpayer Advocate Service has recommended requiring information reporting on payments made to corporations, and the administration's fiscal year 2007 budget has proposed requiring additional information reporting on certain good and service payments by federal, state, and local governments.

- Requiring tax withholding or information reporting on payments made to partners or shareholders. Due to concerns about the tax compliance of partners and shareholders, IRS recently has studied their reporting of their share of the net income and losses passed through from partnerships and S corporations, respectively.1 These areas can be complex to administer. Requiring some form of withholding or enhanced information reporting by these pass-through entities could boost voluntary compliance and help IRS to collect at least some of the taxes owed.

When evaluating proposals to expand information reporting or withholding requirements, it may be instructive to consider the following factors:

- Is there a practical, reliable third party that can withhold taxes from or report information on income taxpayers earn? For example, informal suppliers by definition receive income in an informal manner through services they provide to a variety of individual citizens or small businesses. Whereas businesses may have the capacity to perform withholding and information reporting functions, it may be challenging to extend withholding or information reporting responsibilities to the individual citizens that receive services, as they may not have the resources or knowledge to comply with such requirements.

- Are the costs and burdens imposed on reporting/withholding parties reasonable given the expected improvement in tax compliance? For example, expanding information reporting on securities sales to include basis information will impose costs on the brokers that would track and report the information. Further, trying to close the entire tax gap with these enforcement tools could entail more intrusive recordkeeping or reporting than the public is willing to accept. Considering these costs and burdens should be part of any evaluation of additional withholding or information reporting requirements.

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[1]Partnerships and S corporations are flow-through entities that distribute net income and losses to their partners and shareholders who are required to report them on their individual tax returns and pay any taxes.

4) In your view, what role should tax reform and simplification play in reducing the tax gap, and what factors should Congress consider in evaluating these types of proposals as a way to reduce the tax gap?

Simplification has great potential to reduce the tax gap for at least 3 broad reasons. First, it could help taxpayers to comply voluntarily with more certainty, reducing inadvertent errors by those who want to comply but are confused because of complexity. Second, it may limit opportunities for tax evasion, reducing intentional noncompliance by taxpayers who can misuse the complex code provisions to hide their noncompliance or to achieve ends through tax shelters. Third, tax code complexity may erode taxpayers' willingness to comply voluntarily if they cannot understand its provisions or they see others taking advantage of complexity to intentionally underreport their taxes.

Although retaining but simplifying tax code provisions may help reduce the tax gap, doing so may not be easy, may conflict with other policy decisions, and may have unintended consequences. For example, eliminating or consolidating certain tax credits and deductions would simplify the tax code. However, these credits and deductions serve purposes that Congress has judged to be important to advance federal goals. Eliminating them or consolidating them likely would be complicated, and would likely create winners and losers. Elimination also could conflict with other objectives such as encouraging certain economic activity or improving equity.

Fundamental tax reform would most likely result in a smaller tax gap if the new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent. However, these characteristics are difficult to achieve in any system and experience suggests that simply adopting a fundamentally different tax system may not by itself eliminate any tax gap. Any tax system could be subject to noncompliance, and their design and operation, including the types of tools made available to tax administrators affect the size of any corresponding tax gap.

Some factors to consider when evaluating fundamental tax reform proposals include whether proposed tax systems over time will generate enough revenue to fund expected expenditures, whether the base is as broad as possible so rates can be as low as possible, whether the system meets our future needs, and whether it has attributes that promote compliance. Our publication, Understanding the Tax Reform Debate (GAO-05-1009SP), provides background, criteria, and questions that policymakers may find useful.

HEARING ON LONG-TERM ECONOMIC AND BUDGET CHALLENGES

THURSDAY, JANUARY 18, 2007

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, Lautenberg, Cardin, Sanders, Whitehouse, Gregg, Allard, Bunning, and Crapo.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. I will call the hearing to order.

I wanted to especially welcome the Chairman of the Federal Reserve, Mr. Bernanke, to the Budget Committee. We have, over the years, had a tradition in this committee of hearing from the Chairman of the Federal Reserve on the economic conditions of the country and the challenges that we face, the opportunities that are there. And so this is a continuation of that tradition.

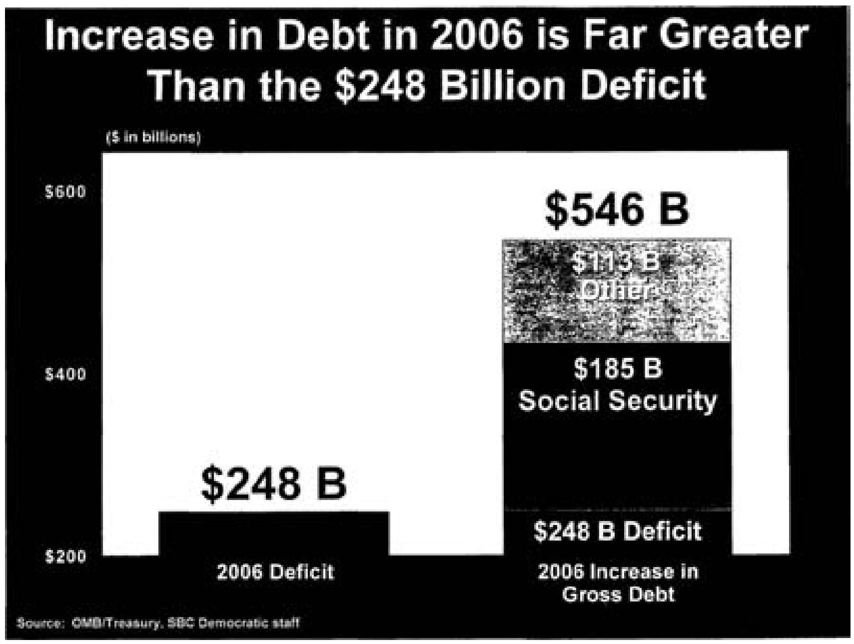
Some weeks ago I had a chance to visit with Chairman Bernanke over lunch and it was, I thought, a constructive and productive discussion. We certainly valued it for the insights to the fundamental underpinnings of our economy and what we could do to make things better and more secure for the future.

Senator Gregg and I are especially committed to facing up to our long-term fiscal imbalances, the challenges that we confront with Medicare and Social Security, and the embedded deficits that we now face. We are very eager for the Congress of the United States and the White House to work together to devise a long-term plan to face up to these challenges because we think they pose a risk to our long-term economic security.

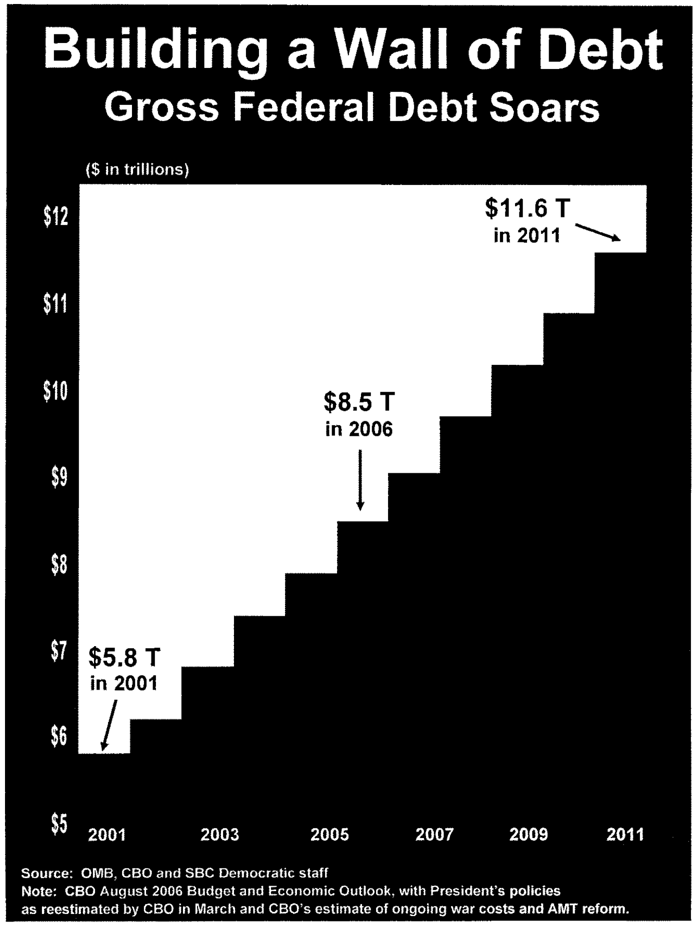
I have noticed increasing discussion in the press about the need to address these long-term imbalances. I wanted to just go through a few slides, if I could, and talk about some of the issues that we think are important to keep in mind.

First of all, the deficit last year was reported at $248 billion. At the same time, the debt of the country increased by $546 billion. All too often these increases in the debt get left out of the reporting.

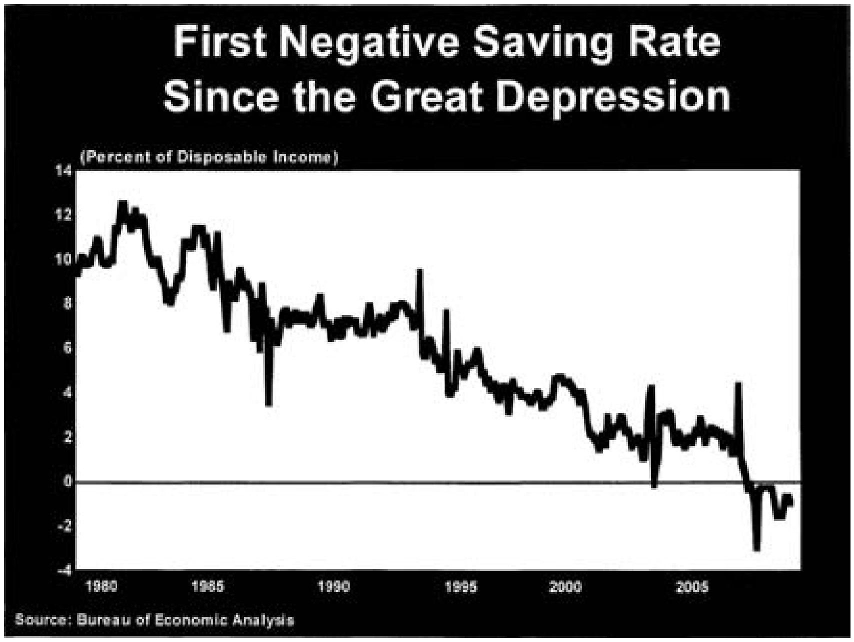
The biggest reason for the difference is Social Security, where $185 billion of Social Security Trust Fund money that is in temporary surplus was used to pay other bills.



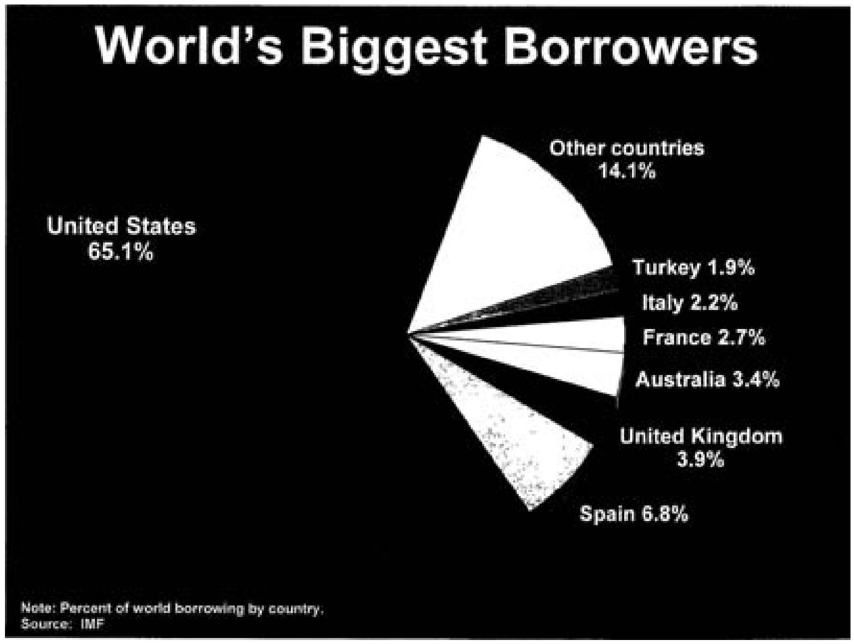
The result of this pattern of increasing deficits and debt, on the debt side of the ledger, is that we are building this wall of debt. At the end of 2001, we had $5.8 trillion of gross debt. At the end of last year, that had soared to $8.5 trillion. If we stay on the current course, the estimates are by 2011 we will be $11.6 trillion of debt.



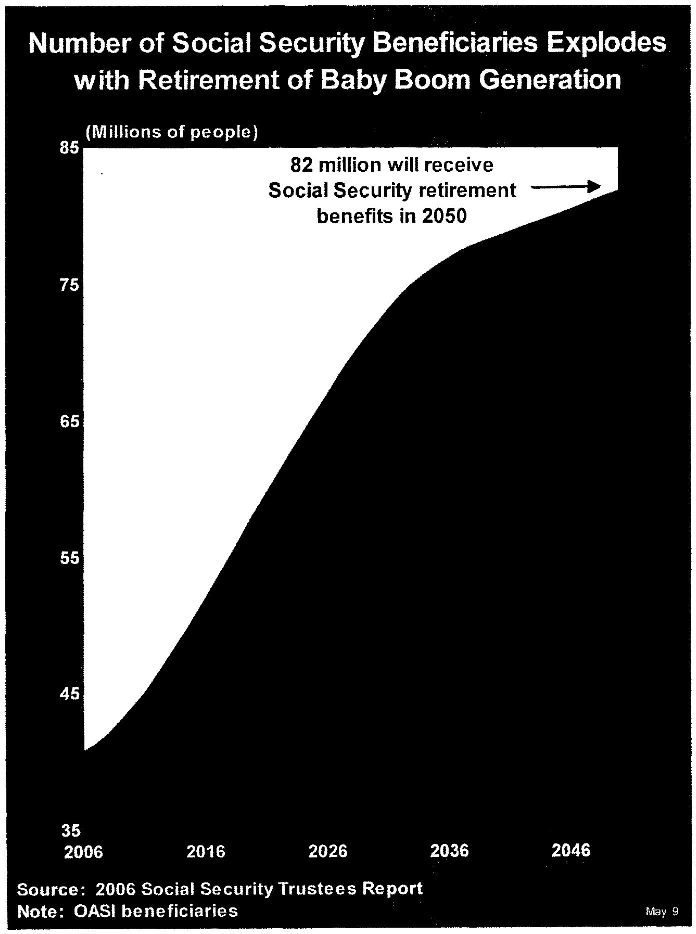
All of this is compounded by a dramatic reduction in the savings rate in this country. Of course, when you have dissavings by the Federal Government, when the Federal Government is running deficit, that reduces the savings rate. This is the individual savings rate according to the Bureau of Economic Analysis. We see the first negative savings rate in 2006 since the Great Depression.



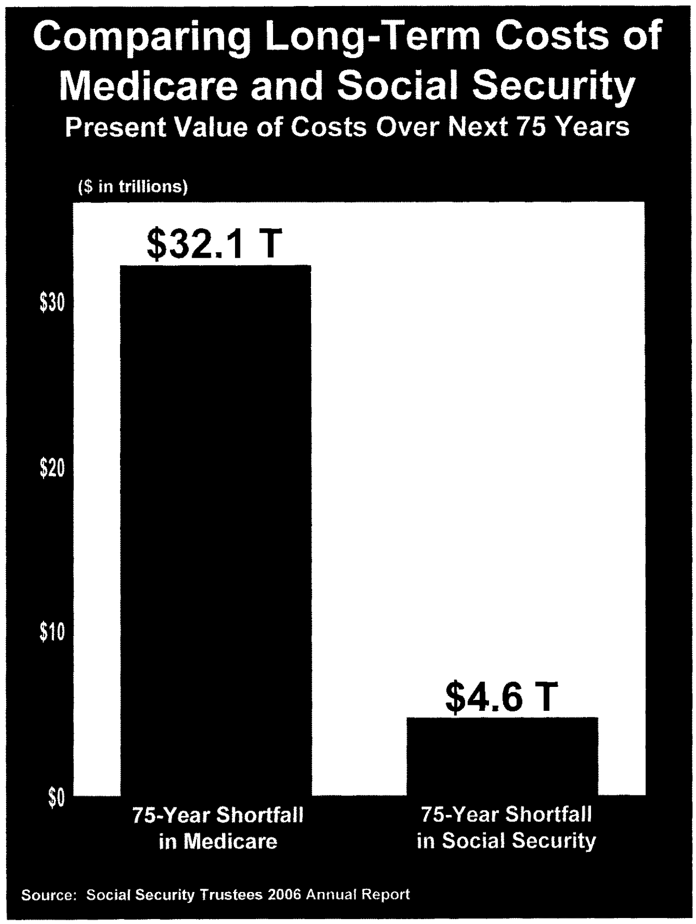
As a result of the twin deficits, budget deficit and trade deficit, we are now borrowing extraordinary amounts of money. Last year we borrowed 65 percent of all of the money that was borrowed by countries in the world. The next biggest borrower was Spain, at about one-tenth as much. Many of us believe this is an unsustainable level of borrowing and has to be addressed.



Of course, all of this is occurring before the baby boomers retire. The baby boom generation, that is going to dramatically increase the number of people eligible for Social Security and Medicare from some 40 million today to over 82 million by 2050, fundamentally changes the decisions that we must make.

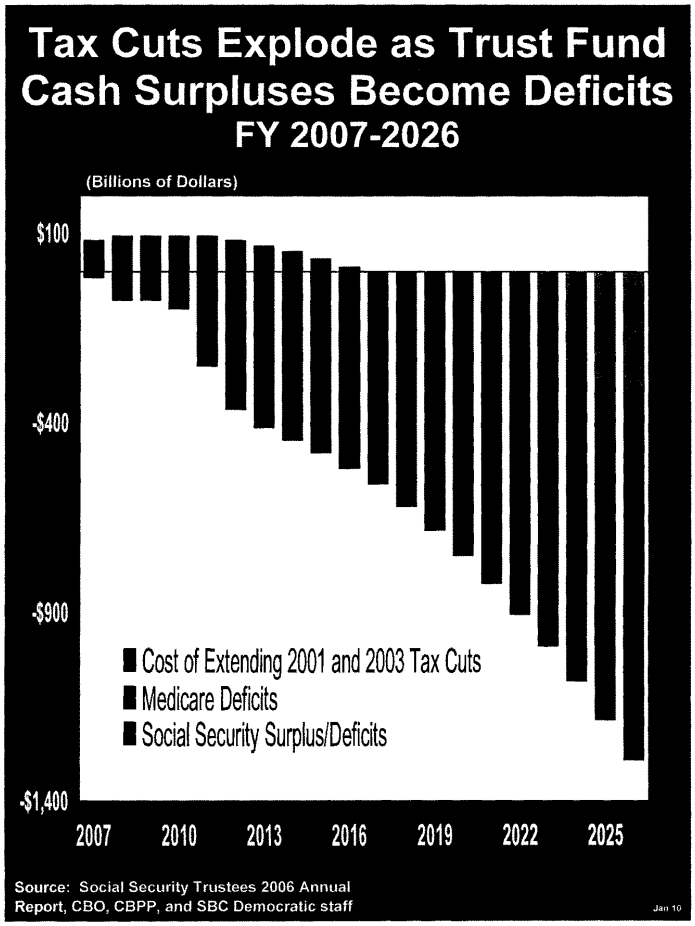


There's been a lot of talk about Social Security and the long-term gap between funding and outgo in that program, the 75-year shortfall in Social Security is about $4.6 trillion. That is the estimate. But the 75-year shortfall in Medicare is much bigger, seven times as much, $32 trillion. This is, many of us believe, the 800-pound gorilla. These health care accounts, Medicare being the most prominent but Medicaid and veterans' health care also part of the consideration.



Not only do we have a problem on the spending side of the ledger, but we also have a problem on the revenue side of the ledger.

This chart shows what happens if you extend all of the tax cuts from 2001 and 2003 and you combine them with the trust funds going negative because out in the future, as we get toward 2017, 2018, these trust funds that are throwing off large cash surpluses now go cash negative. And at that very time, you can see by the chart, the cost of making all of the tax cuts permanent explodes as well, driving us right over a cliff into much deeper deficits and debt. So we're going to have to face both the spending side of the equation and the revenue side of this equation if we are going to be successful.



Why does it matter? Are these just numbers on a page, not attached to the economic condition of our country? No. We think these things are very much linked to the long-term economic security of America. We saw in the Wall Street Journal, the Economic Forum warned that U.S. budget deficits in America are causing our economy to be less competitive. This is the World Economic Forum judgment last year that reduced the competitive ranking of our country because of our very large deficits, both trade and budget.

THE WALL STREET JOURNAL.

WEDNESDAY, SEPTEMBER 27, 2006

Economic Forum Warns U.S. Of Budget Deficit's Ill Effects

By Marcus Walker

The U.S.'s huge budget deficit threatens to make the country's economy less competitive, according to a study by the World Economic Forum, an institute in Switzerland.

The institute's annual study of global competitiveness says the U.S. economy is the sixth most-competitive in the world, slipping from first place in last year's ranking, a result of mediocre scores for its public finances.

Switzerland ranks No. 1 in this year's survey, thanks to what the forum sees as a combination of efficient public administration and flexible markets. Three Nordic countries—Finland, Sweden and Denmark—come next, followed by Singapore and the U.S.

The competitiveness study ranks countries according to a range of criteria—including macroeconomic policies, market regulations, technological development, education systems and public institutions—that the forum believes influence an economy's level of productivity, and thereby its ability to sustain economic growth over many years. The ranking combines economic indicators with the findings from a survey of business executives.

"The U.S. remains a very competitive economy," said Augusto Lopez-Claros, the forum's chief economist. "It leads in innovation and patent registrations, has some of the best universities in the world, and it has extremely high levels of collaboration between universities and industry," he said. "However, how you manage your public finances is very important."

Serial budget deficits in the U.S. have led to rising public debt, which means an increasing portion of government spending goes toward debt service. That means less money is available for spending on infrastructure, schools or other investments that could boost productivity. Heavy government borrowing, which means competing for money in financial markets with the private sector, also tends to drive up businesses' borrowing costs.

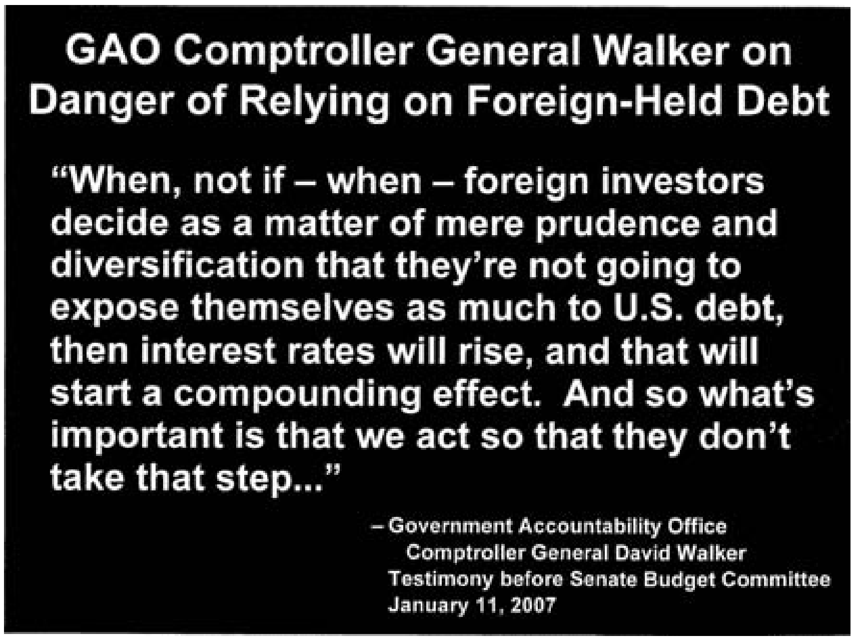
Middling scores were awarded to the fast-growing emerging economies of the world considered to be changing the economic balance of power: India ranks 43rd out of 125 countries in the survey, China ranks 54th, Russia 62nd and Brazil 66th.

Russia and China, despite good scores for macroeconomic management, are marked down for a lack of transparency and even-handedness in their public institutions, including their bureaucracy and judiciary, and for protections for property rights. Brazil is making progress on improving its public finances, but at too slow a pace, according to Mr. Lopez-Claros. Of the four countries, only India improved its ranking in the survey this year.

Although many economists and investors believe economic output in these four countries will overtake that of most of the world's established economic powers by midcentury, the World Economic Forum warns that the emerging economies' growth could hit barriers unless they develop more-efficient public institutions.

The Comptroller General who was the first witness before the Budget Committee, said this in his testimony: "When, not if—

when—foreign investors decide as a matter of mere prudence and diversification that they are not going to expose themselves as much to U.S. debt, then interest rates will rise and that will start a compounding effect. And so what's important is that we act so that they don't take that step."



The Financial Times reported that China was forcing the dollar into the spotlight. "China made its presence felt in the currency markets this week"—and this was in November of last year—"China made its presence felt in the currency markets this week as the prospect of the country diversifying its large foreign exchange stockpiles sent the dollar reeling to a 10-week low against the euro and to its weakest level in 18 months against the sterling."

WEEKEND

FINANCIAL TIMES

China forces dollar into the spotlight

By Peter Garnham

China made its presence felt in the currency markets this week as the prospect of the country diversifying its large foreign exchange stockpiles sent the dollar reeling to a 19-week low against the euro and to its weakest level in 18 months against sterling.

On Monday, China's state television network reported that its foreign currency reserves, the world's largest, had exceeded $1,000bn for the first time.

Analysts said while that was widely expected, it might spark a debate about the renminbi, which many of China's trading partners believed was undervalued.

However, it was the dollar that was thrust into the spotlight as Fan Gang, director of China's National Economic Research Institute and member of China's monetary policy committee, went on the offensive.

Mr Fan said the real problem the world faced was an overvalued dollar, not only against the renminbi but against all leading currencies. "The main responsibility for this imbalance lies with the US Treasury, which is printing too much money," he said.

Analysts said that with 70 per cent of China's reserves thought to be in dollars and Chinese officials making noises about the currency's overvaluation, there was a chance that the country was considering a fundamental change in reserve allocation.

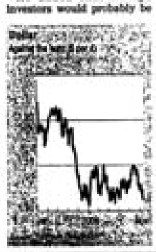
The dollar was sent tumbling on Thursday after Zhou Xiaochuan, governor of the People's Bank of China, said the country was "considering lots of instruments" to diversify its foreign exchange reserves.

Over the week, the dollar fell 1.1 per cent to $1.2960 against the euro, fell 0.7 per cent to $1.9140 against sterling and dropped 0.4 per cent to Y117.50 against the yen.

Marc Chandler, currency strategist at Brown Brothers Harriman in New York, said Mr Zhou's remarks were nothing new and that dollar bears had merely used them as an excuse to sell the greenback.

"The real source of pressure on the dollar at present is not China's $1,000bn of reserves, but the US's $80bn, which is roughly the value of the US Treasury bonds maturing and coupon payments due on November 15," said Mr Chandler.

He added that foreign investors would probably be receiving about 40 per cent of those payments.



Mr Chandler said that the continuing reduction of the US interest rate premium over the eurozone might encourage leakage of the payments away from simply being recycled into US Treasuries and put more pressure on the dollar.

The euro had a strong week, rising to a record high against the yen and climbing to a one-month peak against sterling amid increasingly hawkish rhetoric from the European Central Bank.

Writing in the Financial Times, Jean-Claude Trichet, president of the ECB, advocated the use of money supply data as well as price data in interest rate decision making.

Analysts said that stressing its role at a time when eurozone money supply was growing at a rate close to its fastest since 1999 pointed to a willingness on Mr Trichet's part to tighten eurozone monetary policy further after the 25 basis point rise widely expected next month.

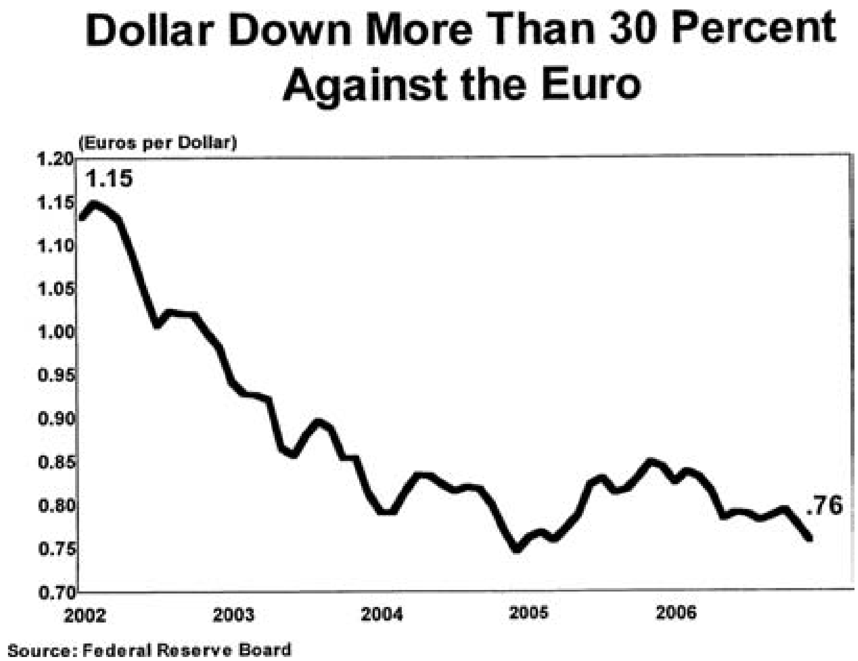
The euro rose 0.6 per cent to £0.6720 against sterling and 0.1 per cent to Y151.00 against the yen.

The euro's rise against sterling was exacerbated as the Bank of England struck a neutral tone on the future path of UK interest rates after raising them to 5 per cent after its monthly policy meeting.

The euro's climb against the yen set off alarm bells in Tokyo. Toshihiko Fukui, governor of the Bank of Japan, voiced concern about the effects on the yen of a sharp unwinding of carry trades, where investors borrow in currencies with low interest rates to invest in high-yielding assets.

Mansoor Mohi-uddin, chief foreign exchange strategist at UBS, said Mr Fukui's remarks were the most explicit to date on the subject and showed that Japanese policymakers had become worried about the size of short yen positions in the market.

Let's go to the final chart, that shows what has happened to the dollar against the euro. Since 2002 the dollar is down about 30 percent. This should be a warning signal to all of us about the potential effect of our fiscal and monetary policies and how it can have an effect on the larger economic well-being of the country.



Let me indicate to Chairman Bernanke that we are not going to ask you about dollar valuation. We are not going to ask about short-term interest rate movements, because we know that is not appropriate in your role as Chairman of the Fed. We want to indicate to all of the members that the Chairman is constrained in what he can say on dollar valuation, on interest rates, and we understand that and respect it.

With that, Senator Gregg.

OPENING STATEMENT OF RANKING MEMBER SENATOR JUDD GREGG

Senator GREGG. Thank you, Mr. Chairman. And thank you, Mr. Chairman, for joining us today. It is very important to hear your thoughts.

The Chairman has set the table on the issue that we consider—the two of us, I believe—to be the primary fiscal policy issue which we face as a country, which is the out-year cost of our Government to America.

It is a function, as the Chairman mentioned, of demographics. I think this just needs to be reinforced. We are facing the largest retirement generation in the history of the country. It will double the size of the people in the retirement generation. The practical effect of that, of course, is that you will have fewer people working to support the retired population.

The implications of this are really reflected in this chart, where three major Federal programs, Social Security, Medicare, and Medicaid, will absorb what has traditionally been the historical amount of spending which the Federal Government takes out of the economy, 20 percent, by about the year 2025. So at that point there will be nothing else the Federal Government can theoretically do and maintain a 20 percent burden on our national economy other than pay for Social Security, Medicare, and Medicaid. National defense cannot be done, education cannot be done, environmental protection cannot be done.

And the problem worsens as the baby boom generation goes into full retirement. The number goes up and almost hits 30 percent, those three programs, as we head into the 2030 decade.

The practical implications of this are staggering for us as a Nation, as the chairman has outlined. The question becomes how do we address it? The issue is reflected, I think, in the fact that if historically we have taken 20 percent of the national economy as the Federal spending, and historically taken about 18.2 percent of the national economy in tax revenues, how high can the Federal Government go into its burden on the national economy without undermining the productivity of the economy and pushing us into some sort of spiraling down in quality of life, quality of experience for our next generation? Or to put it in real terms, at what point does the cost of the retired generation get so high that the younger generation can no longer afford to have the quality of life that our generation has had?

This is reflected in the unchecked effect on Federal spending. It would go as high as, theoretically, 45 percent of the gross national product just on entitlements if it goes forward into the years 2040.

And that is reflected even though we have seen dramatic increases in taxes. The Chairman has pointed out that, in his view, tax revenues in the future, if we continue to maintain the tax cuts which we have in place or the tax burden which we have in place, would significantly drop. I am not sure. I do not happen to believe that. That is a static estimate of what tax revenues are.

We have actually seen that with a fair tax rate we create more productivity in the economy, and has a result we create more revenues for the Federal Government. In fact, in the last 3 years Federal revenues have jumped more significantly than at any other time in history. We are seeing that we are now over the historical norm. We are over 18.2 percent of the national gross product coming in in revenues. We are about 18.5 percent. We headed toward 19 percent if the estimates of the administration are correct, and I suspect those estimates are going to be assumed in whatever budget comes out of this committee. As a practical matter, we even have a more progressive tax law today than we had during the Clinton years.

So even though we have cut rates, we have actually generated a higher—we have actually caused the higher income people in this country to be paying more of the tax burden, 84, 85 percent of the tax burden, versus 81 percent under the Clinton years, the top 20 percent.

So I do not believe you can tax your way of this problem. There are basically four different approaches to this problem: increase taxes, adjust benefits, increase the number of people paying in which would be expanding immigration, I presume; or inflating our way out of the issue.

And I guess what I am going to want to focus on with you, Mr. Chairman, is at what level will the Federal Government be taking too much out of the economy to make the economy work right and be productive? And second, how do we address the issue of the fact that one of the options here is inflating your way out of this problem? Which would be a horrific decision on our part as a Government, but potentially something that the marketplace might force on us, looking at this type of debt burden facing us.

So I am going to be interested in your thoughts on this critical issue of fiscal policy for us and hopefully you can give us some guidance. Thank you.

Chairman CONRAD. Again, our welcome, and please proceed with your testimony. We are very pleased that you are here, Chairman Bernanke.

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

Chairman BERNANKE. Thank you, Chairman Conrad, Senator Gregg, and other members of the committee.

I am pleased to be here to offer my views on the Federal budget and related issues. At the outset, I should underscore that I speak for myself only and not for the Federal Reserve.

As you know, the deficit and the unified Federal budget declined for a second year in fiscal 2006 following the $248 billion from $319 billion in fiscal 2005.

As was the case in the preceding year, the improvement in 2006 was primarily the result of solid growth in tax receipts, especially in collections of personal and corporate income taxes. Federal Government outlays in fiscal 2006 were 20.3 percent of nominal gross domestic product, receipts were 18.4 percent of GDP, and the deficit—equal to the difference of the two—was 1.9 percent of GDP. These percentages are close to their averages since 1960.

The on-budget deficit, which differs from the unified budget deficit primarily in excluding the receipts and payments to the Social Security system—to which Senator Conrad made allusion—was $434 billion or 3.3 percent of GDP in fiscal 2006. As of the end of fiscal 2006, Federal Government debt held by the public, which includes holdings by the Federal Reserve but excludes those held by Social Security and other trust funds, amounted to about 37 percent to 1 year's GDP.

Official projections suggest that the unified budget deficit may stabilize or moderate further over the next few years. Unfortunately, we are experiencing what seems likely to be the calm before the storm. In particular, spending on entitlement programs will begin to climb quickly during the next decade. In fiscal 2006, Federal spending for Social Security, Medicare, and Medicaid together totaled about 40 percent of Federal expenditures, or roughly 8.5 percent of GDP.

In the most recent long-term projections prepared by the Congressional Budget Office these outlays are projected to increase to 10.5 percent of GDP by 2015, an increase of about 2 percentage points of GDP in less than a decade. By 2030, according to the

CBO, they will reach about 15 percent of GDP. As I will discuss, these rising entitlement obligations will put enormous pressure on the Federal budget in coming years.

The large projected increases in future entitlement spending have two principal sources. First, like many other industrial countries, the United States has entered what is likely to be a long period of demographic transition, the result both of the reduction in fertility that followed the post-World War II baby boom and of ongoing increases in life expectancy. Longer life expectancies are certainly to be welcomed. But they are also likely to lead to longer periods of retirement in the future, even as the growth rate of the work force declines. As a consequence of the demographic trends, the number of people of retirement age will grow relative both to the population as a whole and to the number of potential workers.

Currently, people 65 years and older make up about 12 percent of the U.S. population and there are about five people between the ages of 20 and 64 for each person 65 and older. According to the intermediate projections of the Social Security Trustees, in 2030 Americans 65 and older will constitute about 19 percent of the U.S. population and the ratio of those between the ages of 20 and 64 to those 65 and older will have fallen to about three.

Although the retirement of the baby boomers will be an important milestone in this demographic transition, the oldest baby boomers will be eligible for Social Security benefits just next year, the change in the Nation's demographic structure is not just a temporary phenomenon related to the large relative size of the baby boom generation. Rather, if the US fertility rate remains close to current levels and life expectancies continue to rise, as demographers generally expect, the U.S. population will continue to grow older, even after the baby boom generation has passed from the scene. If current law is maintained, that aging of the U.S. population will lead to sustained increases in Federal entitlement spending on programs that benefit older Americans such as Social Security and Medicare.

The second cause of rising entitlement spending is the expected continued increase in medical costs per beneficiary. Projections of future medical costs are fraught with uncertainty, but history suggests that, without significant changes in policy, these costs are likely to continue to rise more quickly than incomes, at least for the foreseeable future. Together with the aging of the population, ongoing increases in medical costs will lead to a rapid expansion of Medicare and Medicaid expenditures.

Long-range projections prepared by the CBO vividly portray the potential effects on the budget of an aging population and rapidly rising health care costs. The CBO has developed projections for a variety of alternative scenarios based on different assumptions about the evolution of spending and taxes. The scenarios produce a wide range of possible budget outcomes, reflecting the substantial uncertainty that attends long-range budget projections. However, the outcomes that appear most likely, in the absence of policy changes, involve rising budget deficits and increases in the amount of Federal debt outstanding to unprecedented levels.

For example, one plausible scenario is based on the assumptions that Federal retirement and health spending will follow the CBO's intermediate projection; that defense spending will drift down over time as a percentage of GDP; that other non-interest spending will grow roughly in line with GDP; and that Federal revenues will remain close to their historical share of GDP, that is, about where they are today. Under these assumptions, the CBO calculates that by 2030 the Federal budget deficit will approach 9 percent of GDP, more than four times greater as a share of GDP than the deficit in fiscal year 2006.

A particularly worrisome aspect of this projection and similar ones is the implied evolution of the national debt and the associated interest payments to Government bond holders. Minor details aside, the Federal debt held by the public increases each year by the amount of that year's unified budget deficit. Consequently, scenarios that project large deficits also project rapid growth in the outstanding Government debt. The higher levels of debt, in turn, imply increased expenditure on interest payments to bondholders which exacerbates the deficit problem still further. Thus, a vicious cycle may develop in which large deficits lead to rapid growth in debt and interest payments which, in turn, add to subsequent deficits.

According to the CBO projection that I have been discussing, interest payments on the Government's debt will reach 4.5 percent of GDP in 2030, nearly three times their current size relative to national output. Under this scenario, the ratio of Federal debt held by the public to GDP would climb from 37 percent currently to roughly 100 percent in 2030, and would continue to grow exponentially after that. The only time in U.S. history that the debt-to-GDP ratio has been in the neighborhood of 100 percent was during World War II. People at the time understood the situation to be temporary and expected deficits and the debt-to-GDP ratio to fall rapidly after the war, as in fact they did.

In contrast, under the scenario I have been discussing, the debt-to-GDP ratio would rise far into the future at an accelerating rate. Ultimately, this expansion of debt would spark a fiscal crisis which could be addressed only by very sharp spending cuts or tax increases or both.

The CBO projections, by design, ignore the adverse effects that such high deficits would likely have on economic growth. But if Government debt and deficits were actually to grow at the pace envisioned by the CBO scenario, the effects on the U.S. economy would be severe. High rates of Government borrowing would drain funds away from private capital formation and thus slow the growth of real incomes and living standards over time. Some fraction of the additional debt would be likely financed abroad, which would lessen the influence on domestic investment. However, the necessity of paying interest on the foreign held debt would leave a smaller portion of our Nation's future output available for domestic consumption.

Moreover, uncertainty about the ultimate resolution of the fiscal imbalances would reduce the confidence of consumers, businesses, and investors in the U.S. economy with adverse implications for investment and growth.

To some extent, strong economic growth can help to mitigate budgetary pressures and all else being equal fiscal policies that are supportive of growth would be beneficial. Unfortunately, economic growth alone is unlikely to solve the Nation's impending fiscal problems. Economic growth leads to higher wages and profits and thus increases tax receipts, but higher wages also imply increased Social Security benefits as those benefits are tied to wages. Higher incomes also tend to increase the demand for medical services so that indirectly higher incomes may also increase Federal health expenditures.

Increased rates of immigration could raise growth by raising the growth rate of the labor force. However, economists who have looked at the issue have found that even a doubling in the rate of immigration to the United States, from about one million to two million immigrants per year, would not significantly reduce the Federal Government's fiscal imbalance.

The prospect of growing fiscal imbalances and their economic consequences also raises essential questions of intergenerational fairness. As I have noted, because of increasing life expectancy and the decline in fertility, the number of retirees that each worker will have to support in the future, either directly or indirectly through taxes paid to Government programs, will rise significantly. To the extent that Federal budgetary policies inhibit capital formation and increase our net liabilities to foreigners, future generations of Americans will bear a growing burden of the debt and experience slower growth in per capita incomes than would otherwise have been the case.

An important element in ensuring that we leave behind a stronger economy than we inherited, as did virtually all previous generations in this country, will be to move over time toward fiscal policies that are sustainable, efficient, and equitable across generations. Policies that promote private as well as public saving would also help us to leave a more productive economy to our children and grandchildren.

In addition, we should explore ways to make the labor market as accommodating as possible to older people who wish to continue working, as many will as longevity increases and health improves.

Addressing the country's fiscal problems will take persistence and a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the administration, and the American people must confront is how large a share of the Nation's economic resources to devote to Federal Government programs, including transfer programs such as Social Security, Medicare, and Medicaid. Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run.

Thus, Members of the Congress who put special emphasis on keeping tax rates low must accept that low tax rates can be sustained only if outlays, including those on entitlements, are kept low as well. Likewise, members who favor a more expansive role of the Government, including relatively more generous benefits payments, must recognize the burden imposed by the additional taxes needed to pay for the higher spending, a burden that includes not only the resources transferred from the private sector but also any adverse economic incentives associated with high tax rates.

Achieving fiscal sustainability will require sustained efforts and attention over many years. As an aid in charting the way forward, the Congress may find it useful to set some benchmarks against which to gauge progress toward key budgetary objectives. Because no single statistic fully describes the fiscal situation, the most effective approach would likely involve monitoring a number of fiscal indicators, each of which captures a different aspect of the budget and its economic impact.

The unified budget deficit projected forward a certain number of years is an important measure that is already included in the Congressional budgeting process. However, the unified budget deficit does not fully capture the fiscal situation and its effects on the economy, for at least two reasons.

First, the budget deficit by itself does not measure the quantity of resources that the Government is taking from the private sector. An economy in which the Government budget is balanced but in which Government spending equals 20 percent of GDP is very different from one in which the Government's budget is balanced but spending is 40 percent of GDP, as the latter economy has both higher tax rates and a greater role for the Government. Monitoring current and prospective levels of total Government outlays relative to GDP or a similar indicator would help the Congress ensure that the overall size of the Government relative to the economy is consistent with members' views and preferences.

Second, the annual budget deficit reflects only near-term financing needs and does not capture long-term fiscal imbalances. As the most difficult long-term budgetary issues are associated with the growth of entitlement spending, a comprehensive approach to budgeting would include close attention to measures of the long-term solvency of entitlement programs, such as long-horizon present values of unfunded liabilities for Social Security and Medicare.

To summarize, because of demographic changes and rising medical costs, Federal expenditures for entitlement programs are projected to rise sharply over the next few decades. Dealing with the resulting fiscal strains will pose difficult choices for the Congress, the administration, and the American people. However, if early and meaningful action is not taken, the U.S. economy could be seriously weakened with future generations bearing much of the cost. The decisions the Congress will face will not be easy or simple but the benefits of placing the budget on a path that is both sustainable and meets the Nation's long-run needs would be substantial.

I thank you again for allowing me to comment on these important issues and I would be glad to take your questions.

Thank you, Mr. Chairman.

[The prepared statement of Chairman Bernanke follows:]

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Statement of

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

January 18, 2007

Chairman Conrad, Senator Gregg, and other members of the Committee, I am pleased to be here to offer my views on the federal budget and related issues. At the outset, I should underscore that I speak only for myself and not necessarily for my colleagues at the Federal Reserve.

As you know, the deficit in the unified federal budget declined for a second year in fiscal year 2006, falling to $248 billion from $319 billion in fiscal 2005. As was the case in the preceding year, the improvement in 2006 was primarily the result of solid growth in tax receipts, especially in collections of personal and corporate income taxes. Federal government outlays in fiscal 2006 were 20.3 percent of nominal gross domestic product (GDP), receipts were 18.4 percent of GDP, and the deficit (equal to the difference of the two) was 1.9 percent of GDP. These percentages are close to their averages since 1960. The on-budget deficit, which differs from the unified budget deficit primarily in excluding receipts and payments of the Social Security system, was $434 billion, or 3.3 percent of GDP, in fiscal 2006.[1] As of the end of fiscal 2006, federal government debt held by the public, which includes holdings by the Federal Reserve but excludes those by the Social Security and other trust funds, amounted to about 37 percent of one year's GDP.

Official projections suggest that the unified budget deficit may stabilize or moderate further over the next few years. Unfortunately, we are experiencing what seems likely to be the calm before the storm. In particular, spending on entitlement programs will begin to climb quickly during the next decade. In fiscal 2006, federal spending for Social Security, Medicare, and Medicaid together totaled about 40 percent of federal expenditures, or roughly 8-1/2 percent

[1] Excluding the operations of both Social Security and Medicare Part A, the budget deficit in fiscal year 2006 was $459 billion, or 3.5 percent of GDP. Like Social Security, Medicare Part A pays benefits out of, and receives a dedicated stream of revenues into, a trust fund.

of GDP.[2] In the most recent long-term projections prepared by the Congressional Budget Office (CBO), these outlays are projected to increase to 10-1/2 percent of GDP by 2015, an increase of about 2 percentage points of GDP in less than a decade. By 2030, according to the CBO, they will reach about 15 percent of GDP.[3] As I will discuss, these rising entitlement obligations will put enormous pressure on the federal budget in coming years.

The large projected increases in future entitlement spending have two principal sources. First, like many other industrial countries, the United States has entered what is likely to be a long period of demographic transition, the result both of the reduction in fertility that followed the post-World War II baby boom and of ongoing increases in life expectancy. Longer life expectancies are certainly to be welcomed. But they are likely to lead to longer periods of retirement in the future, even as the growth rate of the workforce declines. As a consequence of the demographic trends, the number of people of retirement age will grow relative both to the population as a whole and to the number of potential workers. Currently, people 65 years and older make up about 12 percent of the U.S. population, and there are about five people between the ages of 20 and 64 for each person 65 and older. According to the intermediate projections of the Social Security Trustees, in 2030 Americans 65 and older will constitute about 19 percent of the U.S. population, and the ratio of those between the ages of 20 and 64 to those 65 and older will have fallen to about 3.

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[2] Net of Medicare premiums paid by beneficiaries and amounts paid by states from savings on Medicaid prescription drug costs, these outlays were equal to 8 percent of GDP.

[3] These projections are for the CBO's intermediate spending path. Consistent with the assumptions used by the Medicare trustees, this path is based on the assumption that, over the long run, per beneficiary health expenditures will increase at a rate that is 1 percentage point per year greater than the growth rate of per capita GDP. Over the past twenty-five years, however, per beneficiary Medicare spending has actually exceeded per capita GDP growth by about 2-1/2 percentage points per year. Thus, a significant slowing in the growth of medical costs per beneficiary will be needed to keep expenditures close to those projected in the CBO's intermediate-spending scenario. See Congressional Budget Office (2005), *The Long-Term Budget Outlook*, December, www.cbo.gov/ftpdocs/69xx/doc6982/12-15-LongTermOutlook.pdf.

Although the retirement of the baby boomers will be an important milestone in the demographic transition--the oldest baby boomers will be eligible for Social Security benefits starting next year--the change in the nation's demographic structure is not just a temporary phenomenon related to the large relative size of the baby-boom generation. Rather, if the U.S. fertility rate remains close to current levels and life expectancies continue to rise, as demographers generally expect, the U.S. population will continue to grow older, even after the baby-boom generation has passed from the scene. If current law is maintained, that aging of the U.S. population will lead to sustained increases in federal entitlement spending on programs that benefit older Americans, such as Social Security and Medicare.

The second cause of rising entitlement spending is the expected continued increase in medical costs per beneficiary. Projections of future medical costs are fraught with uncertainty, but history suggests that--without significant changes in policy--these costs are likely to continue to rise more quickly than incomes, at least for the foreseeable future. Together with the aging of the population, ongoing increases in medical costs will lead to a rapid expansion of Medicare and Medicaid expenditures.

Long-range projections prepared by the CBO vividly portray the potential effects on the budget of an aging population and rapidly rising health care costs. The CBO has developed projections for a variety of alternative scenarios, based on different assumptions about the evolution of spending and taxes. The scenarios produce a wide range of possible budget outcomes, reflecting the substantial uncertainty that attends long-range budget projections.[4] However, the outcomes that appear most likely, in the absence of policy changes, involve rising budget deficits and increases in the amount of federal debt outstanding to unprecedented levels.

[4]For example, in 2030, five of the six scenarios imply deficits ranging from 1-1/2 percent of GDP to nearly 14 percent of GDP; a sixth scenario is capable of producing a surplus, but it relies on the confluence of a very favorable set of assumptions.

Addressing the country's fiscal problems will take persistence and a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the Administration, and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including transfer programs such as Social Security, Medicare, and Medicaid. Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. Thus, members of the Congress who put special emphasis on keeping tax rates low must accept that low tax rates can be sustained only if outlays, including those on entitlements, are kept low as well. Likewise, members who favor a more expansive role of the government, including relatively more-generous benefits payments, must recognize the burden imposed by the additional taxes needed to pay for the higher spending, a burden that includes not only the resources transferred from the private sector but also any adverse economic incentives associated with higher tax rates.

Achieving fiscal sustainability will require sustained efforts and attention over many years. As an aid in charting the way forward, the Congress may find it useful to set some benchmarks against which to gauge progress toward key budgetary objectives. Because no single statistic fully describes the fiscal situation, the most effective approach would likely involve monitoring a number of fiscal indicators, each of which captures a different aspect of the budget and its economic impact. The unified budget deficit, projected forward a certain number of years, is an important measure that is already included in the congressional budgeting process. However, the unified budget deficit does not fully capture the fiscal situation and its effect on the economy, for at least two reasons.

First, the budget deficit by itself does not measure the quantity of resources that the government is taking from the private sector. An economy in which the government budget is balanced but in which government spending equals 20 percent of GDP is very different from one in which the government's budget is balanced but its spending is 40 percent of GDP, as the latter economy has both higher tax rates and a greater role for the government. Monitoring current and prospective levels of total government outlays relative to GDP or a similar indicator would help the Congress ensure that the overall size of the government relative to the economy is consistent with members' views and preferences.

Second, the annual budget deficit reflects only near-term financing needs and does not capture long-term fiscal imbalances. As the most difficult long-term budgetary issues are associated with the growth of entitlement spending, a comprehensive approach to budgeting would include close attention to measures of the long-term solvency of entitlement programs, such as long-horizon present values of unfunded liabilities for Social Security and Medicare.

To summarize, because of demographic changes and rising medical costs, federal expenditures for entitlement programs are projected to rise sharply over the next few decades. Dealing with the resulting fiscal strains will pose difficult choices for the Congress, the Administration, and the American people. However, if early and meaningful action is not taken, the U.S. economy could be seriously weakened, with future generations bearing much of the cost. The decisions the Congress will face will not be easy or simple, but the benefits of placing the budget on a path that is both sustainable and meets the nation's long-run needs would be substantial.

Thank you again for allowing me to comment on these important issues. I would be glad to take your questions.

Chairman CONRAD. Thank you, Mr. Chairman. I think you have sent a very clear message and one that I hope people are paying close attention to.

As I hear you describe it, we are on a course that is unsustainable and requires our action. Let me ask you this, last week I read in one of the major newspapers that deficits were at

1.8 percent of GDP and so not to worry, that is sustainable for the long-term. What would your reaction be to that notion?

Chairman BERNANKE. Senator, the unified budget deficit is at a normal historical level, but other measures of the deficit would suggest a much more serious situation. For example, there are accrual methods of the budget deficit which incorporate increased obligations to Federal pensions, to veterans' programs and the like, which show a much higher deficit.

But in particular, as I mentioned in my remarks, the short-term unified budget deficit really has nothing to say about the long-term implications of our projected entitlement spending. And that's why I suggested that, in making fiscal plans, the Congress should consider not just the current unified budget deficit, which is sort of a flow measure of current debt, but also measures of long-term solvency such as the present value of unfunded liabilities.

Chairman CONRAD. If we were to put this in plain language for the American people, and you were asked how urgent is this situation? How urgent is it that we address these long-term imbalances, which as you describe could swamp the boat, could have very adverse affect on our economy if we do not take action. How would you rate the urgency of the need for a response by the Government?

Chairman BERNANKE. Senator, one might look at these projections and say well, these are about 2030 and 2040 and so we do not really have to start worrying about it yet. But in fact, the longer we wait the more severe, the more draconian, the more difficult the adjustments are going to be.

I think the right time to start is about 10 years ago. I think we are already well into the process of demographic change. The sooner we can make significant progress, the sooner we can begin to lay out a plan for dealing with these looming fiscal imbalances, the less the adjustment will be, the less the impact will be on the U.S. economy and the easier it will be for our fellow citizens to plan for their own retirements and for the welfare of their children.

Chairman CONRAD. Another thing that is said to me very often is when Senator Gregg and I have made these presentations, people are watching on television. I have had people call my office and say senators, you are you are talking about projections. You are talking about projections for what is going to happen in 20 years. How can you have any confidence in those projections? Aren't you being alarmist by suggesting that there is a big problem down the road?

How would you respond to people who ask that question?

Chairman BERNANKE. Senator, you are correct that the history of budget projections has not always been the most accurate. We have had big swings in recent years, of course. But with respect to the entitlement programs, I would make a couple of comments.

First, the Social Security projections are based on very reliable estimates of where our population is going to be in 20 and 30 years. We know what the population is going to look like because the people are already born. We know the composition of our population. We know how they are going to age.

Chairman CONRAD. So that part of it is really not a projection at all?

Chairman BERNANKE. That part of it is not particularly uncertain.

On Medicare, there is more uncertainty, but I would note that some of the projections that are made are actually somewhat conservative in the following sense: an important assumption about Medicare projections is how quickly will medical costs grow. The standard assumption that is made by the Medicare Trustees is that medical costs per beneficiary will grow at 1 percent a year faster than the average per capita income. In fact, over the last three decades the cost of medical care has grown at 2.3 percent a year faster than average income.

Consequently, to achieve even these very draconian outcomes that the Congressional Budget Office and the Medicare Trustees have presented, we would actually have to have a somewhat significant decline in the growth of medical costs.

So it is certainly true that there is a lot of uncertainty, but there is very good reason to believe that unless very extraordinary changes occur in the cost of medical care, for example, these budget issues are going to be very large and very soon.

Chairman CONRAD. If you would compare for us the challenge of Medicare versus Social Security in terms of the gap between the cost and the revenue associated with it, how would you characterize where the biggest part of the challenge lies?

Chairman BERNANKE. Senator, as I just indicated, there is perhaps more uncertainty about Medicare than there is about Social Security. But the best guess estimates that the Medicare Trustees and others have put together put the very long run imbalances associated with Medicare on something of the order of six times the size of the Social Security deficit. So the Medicare issue is very large.

I would add that to address the Medicare issue we are going to heed to think more broadly about our health care system overall—about how to make it more efficient and how to control costs—so that we can deliver good medical care but without such a rapid increase in medical costs.

Chairman CONRAD. The other thing I think that is important for us to address is what difference does all of this make? I am sitting out there in my living room watching this. You have these economists sitting around a table down in Washington talking about projections 20 years from now. How is this really going to affect my life?

If you were to try to say to a person who might be watching out there, so what? So what if the Government runs a little bigger deficit? How is that really going to affect my life?

Chairman BERNANKE. First, we are going to be seeing this impact on the deficit just a few years from now. It is not that far in the future. If the deficit begins to widen further, we are going to see more draining of funds away from capital formation. That is going to mean the economy is going to grow more slowly. It is going to mean that wages are not going to grow as fast because workers do not have as much capital to work with. It is going to mean that we will be borrowing more from foreign lenders and increasing our obligations to them.

So it will soon have, even if there's no change in fiscal policy, an effect on the vibrancy, the efficiency, the growth rate of our economy, which will be palpable and which Americans will see.

Moreover, to the extent that Americans are counting, for example, on the current-law Social Security benefits and the current payroll taxes, they are going to have a surprise at some point because the two sides are not commensurate in the long run, and they are either going to be finding themselves with lower benefits at retirement than they expected or higher payroll taxes or some combination. And that is also going to affect them in a very real pocketbook kind of way.

Chairman CONRAD. Thank you. I hope people are paying close attention.

Let me just conclude on this question: how about tax cuts? In your judgment and the considered judgment of economists, do tax cuts pay for themselves? Do you get more revenue with a tax cut than you would otherwise have had?

Chairman BERNANKE. The effects of a tax cut depend on the nature of the cut, the type of cut it is, and so on. I think the general view is that tax cuts do not usually pay for themselves. The fact that tax cuts can increase growth or increase the size of the economy means that they partially offset the revenue losses as a usual matter.

But I think the issue with tax policy is not whether the tax cut pays for itself. The question really is what is the balance between taxes and spending that is right for our economy? We do not want to have wasteful spending because that requires higher taxes which are detrimental to economic growth. But important spending, spending we need to do, we are going to have to find a way to finance, and we just would like to find the best possible way to finance that that has the minimum adverse impact on our economy.

Chairman CONRAD. Really the question here is one of balance is it not? If we are going to have a certain level of spending, we have to raise the revenue to pay for it. But we have to keep in mind when we are setting that level of spending that as we raise more and more revenue that has potential adverse impacts on our economic competitiveness, and on economic growth. That is really the kind of balance that you are talking about, is it not?

Chairman BERNANKE. That is exactly right, Senator.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you. Picking up where the Chairman has left off, it comes to the question of the point I made in my opening statement. I happen to believe there are certain tax cuts which pay for themselves, capital gains, for example. Certainly, in the short run it pays for itself.

On the reverse side of that, if you raise taxes to a level where you create a disincentive for productivity or a disincentive to do taxable activity or create an incentive for tax avoidance, because you are taking 60 percent or 50 percent or 70 percent of the next dollar earned, and people say they simply are not going to go out and be productive because they do not want to give the Government the 50, 60, 70 percent. Or they are going to invest in something that is arbitrary and capital flowed then becomes not more efficiently used but inefficiently used to try to avoid taxes, is that not the reverse? That you get tax burden to a level where it is counterproductive to the economy?

Chairman BERNANKE. That is right, Senator. When you raise taxes, you almost always distort incentives. You create what economists call dead weight loss or loss of efficiency. One estimate that has been made is that for every dollar you raise in taxes you not only take a dollar from the economy but you create 20 cents of essentially waste associated with people not making the decisions they would have made in the absence of those taxes.

That is not to say that you should not have taxes. You have to have enough taxes to fund your spending. It just says that as you think about the right level of spending in the economy, as Senator Conrad said, you need to take into account the full effects of those taxes on the broader economy as well as on the budget.

Senator GREGG. I agree with that. And that gets to the point of what is the correct burden of the Federal Government on the economy which you have to fund? Looking at these charts, which your testimony was even more stark than ours, quite honestly, you are looking at numbers that are staggering, 45, 50 percent of GDP being used to support entitlement programs or Government spending, if you were to carry these numbers out. But even a conservative number gets you well over 20 percent, gets you up around 30 percent with the present demographic situation.

So let me ask you four questions, some of which are related and some which are not. The first, is there a range in which the Federal Government should find itself as taking a percent of gross national product? Today it takes 20 percent. It has been as high as 22 percent historically. It has been as low as 18 percent. The revenues for the Federal Government have historically been about 18.2 percent. They have been as high as 22 percent and they have been well below 18 percent, 16 percent.

What is the range that is a reasonable number? And should we not back into what we are looking at as an entitlement or a Government burden from that range? That is the first question.

The second question, I think you have focused on what is the essence of the problem for us, which is health care. Social Security can actually be fixed rather easily and the burden is not dramatic and we can do it. Health care is complex. GAO says it is $60 trillion in unfunded liability. Your number was, I think, $38 trillion. It is huge.

Do you have some concepts as to how we approach the health care? Because that seems to be the gravamen of the question.

On two ancillary issues, because my time will run out before you get to these—

Chairman CONRAD. Feel free to let him answer that.

Senator GREGG. Let me just put these on the table.

Can you give us your thoughts on hedge funds and monitoring hedge funds, and on capital markets and the risk of America losing its role in being the primary premier place where people come to raise capital?

Thank you.

Chairman BERNANKE. Thank you, Senator.

On the range of taxes, I should say now what I will probably be saying several times, which is I am here to try to give economic analysis and help as much as I can. The Federal Reserve, of course, is nonpartisan and does not make the value judgments that Congress has to make in the end. And so I am going to try to avoid making specific recommendations for tax or spending policies. I will just try to comment as an economist on what the issues are that you are raising.

With respect to the range, the fact is that the share of Federal spending in the economy varies a lot across countries. There are countries in Europe, for example, that have much higher shares than we do. I think it is arguable that, for example, they pay some cost for that and it involves, for example, less hours of work in Western Europe, perhaps slower productivity growth.

So I do not think there is a magic number. But when you think about the share of the economy that you take in taxes, and think about the structure of the tax system as well, which is also very important, you really have to make a tradeoff, a balance, between the cost that that imposes on the economy versus what you are paying for.

So I am sorry that I cannot give you a magic number. I will only say that there is a difficult balance and is a variety of international experience. It is interesting to look at other countries and see how they have fared. But ultimately, it is up to the Congress, to make that judgment.

Health care is an enormous topic and there are many issues associated with it. We have, in some ways, the best health care system in the world—in the sense that when it comes to a difficult procedure, this is where people come because we have the best technologies and the best hospitals, the best doctors. But we also have a very inefficient system in that the total cost we pay is much higher than other countries and, in many cases, we do not deliver as productively or as efficiently.

Again it is a large issue. Some of the questions one might want to ask are the costs and benefits of, and how quickly we should try to move to, universal coverage. The benefits of universal coverage include better risk pooling and perhaps lower costs of uncompensated care and the like. But the cost of universal coverage is that we have to make sure that the poor and people with pre-existing conditions are able to buy insurance, and that can be very expensive. So there is a tradeoff.

Another question that Congress has to face is, who is going to manage the health care system? Is it going to be the Government directly, as in the case in parts of Medicare? Will it be via the private sector, as in Medicare Advantage or Part D, where the Federal Government pays part but the private sector, private insurance, HMOs and so on actually manage the care? How will it be funded? There is a raft of questions.

I think one thing that is encouraging to me, as a general matter, is that we are seeing a lot of experimentation: at the Federal level with Medicare, for example, and at the various States. We have seen a number of States which have tried new things, and I think we will learn from that.

But it is a very important matter, and we need to keep this front and center.

I think that even beyond the issue of Medicare for Americans as a whole, the cost of medical care, the portability of insurance, the availability of insurance are very crucial issues for well-being.

May I continue with your other questions, Senator?

On hedge funds, the philosophy the regulators have taken since the President's Working Group issued a report after the LTCM crisis in 1998 has been a market discipline approach. We have tried to discipline hedge funds not by direct regulatory oversight but indirectly, by making sure that the people they trade with, so to speak, have incentives to pay close attention to what they are doing.

So in particular, the Federal Reserve and other bank regulators and the SEC work very hard to make sure that commercial banks and investment banks who are counterparties to hedge funds, who provide brokerage services to hedge funds, are doing due diligence to make sure that the hedge funds are operating in a way that will not pose excessive risk to those counterparties.

Similarly, the SEC is working to make sure that investors in hedge funds have the opportunity and the incentive to impose discipline on those hedge funds, as well.

That system has worked pretty well so far. I think it is always worth reviewing and thinking about how better to manage the system. But that is the general philosophy that we have taken in the regulatory community.

On the capital markets competitiveness, again this is a very big issue. It is true, for example, that the number of initial public offerings taking place in U.S. markets has been much lower in recent years relative to capital markets in other countries. To some extent, that is simply a result of the fact that capital markets in other countries, the UK, in Asia and elsewhere, are growing and maturing, and it is natural that they would take over part of the business as they go forward.

But we also have to look carefully to make sure that our regulatory regime, our broad set of laws and regulations, are not imposing undue burdens on American capital markets and U.S. corporations to ensure that there is a reasonable balance between the costs and benefits of those regulations.

Senator GREGG. Thank you.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you very much, Mr. Chairman. And thank you and the ranking member for holding this important hearing. Mr. Bernanke, thank you very much for your thoughtful comments.

Mr. Bernanke, I would like to discuss with you three issues. No. 1, do you have a concern about the growing income inequality in the United States of America today? The fact that we have by far the most unequal distribution of wealth and income of any major country on earth? The fact that the richest 1 percent own more wealth than the bottom 90 percent. That the richest 13,000 families earn almost income as the bottom 20 million American families. The fact that the middle class is shrinking, poverty is increasing, while the gap between the rich and the poor grows wider? I would like to comment on that in a moment.

My second question deals with the Federal deficit. We have had a number of record-breaking deficits, of course, in recent years. And you and the Chairman and ranking member have highlighted the long-term problems, which I certainly agree with.

But in the midst of all of these deficits, the President of the United States has pledged to make all of his tax cuts permanent, including those to millionaires and billionaires at the time when the wealthiest people in America have never had it so good. Over the next four calendar years the cost of the tax cuts for the top 1 percent of households with average incomes of over $1 million will total nearly $350 billion.

If the President's tax cuts are made permanent, households with annual incomes of more than $1 million, a group that comprises three-tenths of 1 percent, the wealthiest three-tenths of 1 percent would receive approximately $648 billion in tax cuts over the next decade.

So my question to you is could you speak to us about the "wisdom" of the President's policies of continuing to give mammoth tax breaks to the wealthiest people in this country who have never had it so good, and in the process significantly driving up our national debt?

The third issue I would like you to comment on briefly is our trade policy. As you know, our trade deficit is on track to exceed $800 billion in 2006 and we now have a record-breaking $900 billion current account deficit.

There are a number of us in Congress, I think a growing number of Americans, who are now catching on that our current unfettered free trade policy has not only been a disaster in terms of the loss of millions of good paying manufacturing jobs but it is a disaster in terms of long-term economic trends when you run up record breaking trade deficits year after year after year.

In your view, given the fact that we have lost millions of good paying manufacturing jobs, given the fact that we may be losing or on the cusp of losing millions of good paying information technology jobs as a result of unfettered free trade, given the fact that our manufacturing base is virtually collapsing, do you think it is time to perhaps rethink the current trade policies that we have?

Those are the areas that I would very much appreciate your commenting on.

Chairman BERNANKE. Thank you, Senator. Those are all very important issues.

On inequality, it is certainly true that the degree of inequality in our economy has been rising. It has been going on for a long time, and we now have greater income inequality than many other industrial countries.

Senator SANDERS. Is there any other country in the world, major country?

Chairman BERNANKE. There are some, but—

Senator SANDERS. Major countries?

Chairman BERNANKE. Brazil.

Senator SANDERS. OK, Brazil, yes.

Chairman BERNANKE. I think it is an important issue.

First of all, it is part, of the American ethos that we want everyone to have opportunity, economic opportunity, and a good economic standard of living.

It is important also for political reasons in the following sense: our growth and our dynamism depend in an important way on the willingness of the general population to support flexible labor markets, for example, to support the effects of trade on the economy. If people are starting to believe that trade, for example, does not benefit them personally, then they may become less willing to support trade and that, from my perspective, is a concern.

So it is a very large topic. I hope to give some remarks on this fairly soon about some of the causes and responses to it.

Senator SANDERS. But it is an issue. The fact that we have such a huge gap between the rich and the poor and the—

Chairman BERNANKE. Yes, it is certainly an issue. It is something that would be good to address.

I would just reiterate that it is a very long-term trend. It is not something that happened yesterday. And trying to understand it is something economists have been spending a lot of time on. It would be interesting to think further about it.

On the Federal deficit and the tax cut, as I said, I am not going to support or defend or oppose specific tax or spending measures. With tax cuts you face the usual tradeoff: lower taxes tend to improve incentives and generate more efficiency and more growth.

Senator SANDERS. But you just mentioned a moment ago, which I think most economists agree, that tax breaks do not pay for themselves. My question is if you give hundreds of billions of dollars in tax breaks to the wealthiest people who really do not need it, which drives up the deficit, I have a hard time understanding how that makes any sense at all. Can you help me on that?

Chairman BERNANKE. To the extent that—and there is disagreement—but to the extent that the lower marginal rates create additional effort and additional work and additional productivity, additional innovation, they will create a broader growth in the overall economy. Maybe it is worth it. I am just saying there is a balance of issues here. On the one hand is the progressivity issue which you are referring to. On the other hand, is whether the tax code is promoting growth.

May I suggest that there are many ways to increase progressivity. Another way to do it would be to broaden the base. There are a number of deductions, for example, exemptions and exclusions in the tax code, which are not capped and which benefit higher income people more than lower income people. That is another way to look at it.

So there are many different ways to think about how to address progressivity. But in doing so you should think also about the implications for economic growth and efficiency.

On the trade deficit, this ties in very well to the debate we are having today in this meeting. The fundamental source of our trade imbalance is that we, as a country, are saving much less than we are investing. Therefore, we have to borrow the difference abroad. Whereas other countries are saving more than they are investing and therefore they are lending to us the difference. That is the essence of the imbalance that we have in the world today.

Senator SANDERS. Let us get back to the question, if we could, sir. We have an $80 billion trade deficit. We have lost millions of good paying manufacturing jobs, all of which leads myself and many millions of Americans to believe that NAFTA, PNTR with China, et cetera, et cetera, are not working particularly well for the American people.

Comment?

Chairman BERNANKE. I do not agree with that. I think that there are certainly people and workers who are displaced, who lose from trade. But broadly speaking, I believe that trade and openness are good for the economy. Trade creates broader opportunities for growth and investment.

Senator SANDERS. We just have a limited amount, so forgive me. You are giving me the rhetoric. But the fact is you are concerned about deficits. That is why you are here today; right?

We have an $800 billion trade deficit. Is that a concern?

Chairman BERNANKE. The deficit we have been talking about is the fiscal deficit.

Senator SANDERS. Well, but you have a trade deficit that is also of concern.

Chairman BERNANKE. It is a concern, but I do not think it comes from our trade policies. It comes from our saving and investment policies.

Senator SANDERS. You do not think our trade deficit comes from our trade policies?

Chairman BERNANKE. No, I do not.

Senator SANDERS. You do not think a $200 billion trade deficit with China and the fact that it is hard to buy an American product—

Chairman BERNANKE. The connection is very marginal. I would also like to say that I think it is really a bit of an exaggeration to say that the U.S. industrial base is decaying. In fact, we just got good industrial production numbers yesterday. The United States is the largest manufacturing country in the world. Our manufacturing output is growing. We have some of the best high-tech manufacturing industries in the world.

The main reason that manufacturing jobs have declined so quickly is, perversely, because manufacturing has been so productive that firms have found ways to make do with fewer and fewer workers. And that has led to a smaller number of workers in manufacturing. But I do not think it is the trade issue. I think, in that particular case, it is the productivity issue.

I do believe that the best way to address the current account deficit is for a balanced adjustment, for us to increase our saving, both at the household level and at the fiscal level, and for countries like China to increase—

Senator SANDERS. Is it not hard for the average household to increase their savings when, in many cases, the jobs they now have are paying lower wages than what they had 20 years ago?

Chairman CONRAD. Let me just intercede, if I can.

Senator SANDERS. Thank you, Mr. Chairman.

Chairman CONRAD. We are a little past the Senator's time. We will go back to another round.

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

Chairman CONRAD. We will go to Senator Allard.

Senator ALLARD. Dr. Bernanke, welcome to the committee.

I have always believed that there is a certain balance between the level of taxation and revenues. In other words, if you tax 100 percent, you are not going to get any revenues to the Federal Government. If you do not tax anything at all, you are not going to get any revenues—but somewhere in between there is this balance. I think it is referred to as the Laffer curve. I would like to hear you comment a little bit on Laffer's curve, if it plays in your thinking.

I am interested to know whether we have the proper balance today and are maximizing revenues to government, whether it is Federal Government or State governments. If you look at what has happened in the last few years, it seems to me that it is working. But I would just like to get your perspective on that.

Chairman BERNANKE. As I indicated before, the conventional wisdom among economists is that tax cuts do not necessarily pay for themselves. That is not really an argument against tax cuts. It is really a question of balancing the benefits of the tax cuts for the economy against the fact that you would have to reduce Government spending in the long run to get that balance.

I think, in general, that it would be a good idea for us to look at the tax code, to ask ourselves whether there are ways of simplifying it, broadening the base, reducing complexity, reducing compliance costs, and maybe increasing collection that would allow us to get more revenue without greater burden on the economy. The tax code has become a very complex system, and I think periodically it makes sense for Congress to review it and try to find ways to improve it.

Senator ALLARD. But do you worry, in general terms, about the level of taxation and the effect on the economy?

Chairman BERNANKE. The message I am bringing today is only that there is a decision that Congress has to make about how big a government you want. Whatever it is, you have to pay for it. That is what I am saying.

Senator ALLARD. But if you have 100 percent taxation, does that have an effect on the economy?

Chairman BERNANKE. Of course.

Senator ALLARD. Do you understand what I am trying to get at?

Chairman BERNANKE. Let me try to respond. The Laffer curve idea is correct if rates are extraordinarily high. If rates are very high—if they are at 100 percent, 90 percent, so high that they essentially drive out the activity being taxed—then it is true that in that situation you could actually raise revenue by cutting taxes. That is correct.

But I do not think—there may be differences of degree—that for our income tax system we are on that side of the Laffer curve. I think that where we are now, if we cut income taxes, we will probably lose some revenue.

Again, that is not the key question. The key question is balancing the level of taxation and the implications of that for the economy against a level of spending that is appropriate and is really providing good benefits for the economy. That is the balance you have to think about.

Senator ALLARD. It seems to me that when you look at the economic figures that we are looking at today, that you cannot be that critical of where we are today, can you?

Chairman BERNANKE. The economy has recovered quite a bit from the 2001 recession and the weakness that we saw through 2003. We have had a pretty good run in terms of growth and productivity.

Senator ALLARD. Your predecessor, Dr. Greenspan, when he talked about trade he did not concern himself too much with trade deficits. You seem to be more concerned about the trade deficits.

A question I have is does it really matter who purchases our Treasury certificates? In other words, who buys our debt? And if it does matter, does it make a difference whether it is domestically or internationally owned debt?

Chairman BERNANKE. It makes a difference only in that if it is domestically purchased, then the interest on the debt will go to domestic people and be part of the domestic income. If it is purchased by foreigners, it will go to the foreign holders of the debt.

The existence of foreign lenders, in the short run at least, is a good thing because it means that we can invest more than we otherwise could, given the amount of saving we have. So we want to invest more than we save. The only way to do that is to borrow abroad.

The concern I have is that the current account deficit is now quite large and still growing. There is a good reason to believe that ultimately it needs to start coming down slowly. I think that fiscal policies that create better balance between taxes and revenues, between spending and revenues, have a lot of virtues in their own sake. But they would also, to some extent, contribute to bringing down that imbalance on the external side, as well.

Senator ALLARD. The Bureau of Labor Statistics has recently introduced a new price index. They call it the chain CPI. I wonder if you would elaborate on that. They are claiming that that is more accurate than the current CPI that we are using today. I would like to hear your feelings on that new measurement.

Chairman BERNANKE. Senator, yes, I think it is somewhat more accurate. The existing CPI, the one we are all familiar with, takes a fixed basket of goods and values the change in the cost of that basket from month to month, from year to year.

The problem with that is it does not take into account the fact that as prices change, people will change the goods and services that they choose. If oranges become more expensive, I might eat more apples instead.

The chain-weighted CPI allows, to some extent, for the adjustment that people make to go from higher priced goods to lower-priced goods, and therefore is probably a better measure of the true cost of living increase than the standard CPI.

Senator ALLARD. Do you think that the procedure that we are using now with CBO and OMB, that those projections overstate inflation?

Chairman BERNANKE. Presumably, the projections they are making are in terms of what they think the standard CPI inflation will be. At the Federal Reserve, we have done numerous studies of these indices, and we do think, for example, that the standard CPI does overstate true inflation, if we could measure true inflation, by some amount between one-half and 1 percentage point.

Senator ALLARD. Do you think with those agencies we need to go to the chain CPI to get a better result?

Chairman BERNANKE. A really operational question one might ask is whether we should use the chain CPI or some other measure to index entitlement benefits and also to index the tax code. If your objective—as Congress—is to tie benefits payments and the tax code more directly to what I would call true inflation, you would have a more accurate measure of true inflation by using the chain CPI or some alternative measures. So that would be one consideration.

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

Chairman CONRAD. I thank the Senator, and I especially thank him for his question on the CPI matter because I think that is going to be an important part of the discussion here as we try to figure out a way to get this horse back in the barn.

Senator CARDIN.

Senator CARDIN. Thank you very much, Mr. Chairman. Mr. Chairman, it is a pleasure to have you before our committee.

I want to followup on the savings issue. We do talk a lot about the budget deficit and the trade deficit. We have a major savings deficit in this country.

Although I am not really clear of the relationship between the savings deficit and the trade deficit, and I would like to explore that at a different time, I am very concerned about the savings deficit in this country. I think we all are. From an individual point of view, we know that individuals do not have enough put away in savings to deal with life's circumstances. We are well below what economists say we should have for the purposes of individual security.

This also adds to the wealth disparity in America. Those at the lower income levels save the least and are much more vulnerable. And it does put more pressure on us, in Congress, to deal with the entitlement programs.

So for all of those reasons, it is important to increase the national savings rate and increase individual savings rates. And from a national point of view, our savings rates are very, very low. We do not have the amount of savings that are useful for investment in America and that makes it necessary for us to borrow capital from abroad.

Now, one can argue whether our economy is hurt by our indebtedness to countries. But I must tell you because of the large sums borrowed from financial entities that are controlled by other governments that do not always agree with America's foreign policy, I think there is also a security issue here that could compromise country's independence.

I have raised the issue of whether we really can challenge China's monetary policies on how it ties its currency to ours. Are we truly independent on our challenges there, knowing how much capital is coming in from China to America today?

So for all of those reasons, I think we need to improve our domestic savings rates.

I know that you are reluctant to comment on specific proposals. We have passed a savers' credit, which is targeted toward lower-income people. There are efforts being made to increase the savers' credit, to make it easier for lower wage workers to put money away for retirement. To the extent that that type of incentive increases savings by lower income people it seems to me, from your testimony, that would have a very positive effect on our economy.

To the extent that we can encourage businesses to provide retirement plans for their employees, where they put some money on the table, workers are much more likely to participate in those plans. We know this from our experience, with the Federal Employees Thrift Savings Plan (TSP), which the Federal Government contributes to.

Our savings rates are declining, the number of defined benefit plans is declining, and employer-sponsored plans are not increasing at the rate that all of us believe is necessary.

So try to help me on this. I know you are reluctant to make specific recommendations, but the savings deficit, it seems to me, is a major problem for our economy.

Chairman BERNANKE. Senator, first of all, I certainly agree with that.

Senator Sanders asked about inequality. The inequality in wealth and savings is far greater than the inequality in income. I think it is a problem, both for individual families and for our economy as a whole. It has been a long-standing debate in the economic literature about how we can get people to save more.

I think one promising direction which I will comment on, because the Congress has recently moved in this direction, has to do with ideas that have been developed in what is called behavioral economics, which is the idea of merging psychology with economics and using psychological principles.

One of the results of those studies is that if people are told that they have a 401(k) plan at work and are asked whether they would like to contribute to it, they will say no. But if you deduct from their income as a default into their 401(k) plan and ask whether they want to opt out, most of the time they will not. So having an opt-out provision, which still makes it voluntary, actually seems to have some impact on saving behavior.

So recently, in the Pension Bill, there were some provisions that made it easier for employers to do that.

I think that is a promising approach and as you indicate, it could be extended. Even if there is not an employer match, it could be extended to people without 401(k)'s, either through work or through a government program, to allow people to have a tax-favored place to save. So I think that is one promising direction.

The other approach that Congress has taken over the years is various kinds of tax policy, tax breaks and so on, for saving. IRAs are an example. Unfortunately, the evidence is really quite mixed on how well they work. For some people, having tax-free money in an IRA means they can save less or they can just move assets from somewhere else and put them into the IRA. There is quite a controversy about how much those sorts of measures help.

So I think the two things that I would suggest—strangely for an economist—would be not the straight incentive measures but using these psychological methods to try to induce people to understand the importance of saving and to make them opt-out of some kind of plan.

The other thing that is important, and the Federal Reserve is very involved in supporting this, is that people often just do not have the knowledge, the information, about how to invest even in simple ways, how to take advantage of the existing tax breaks and the like. So we, at the Fed, have worked very hard on financial literacy, for example, to try to get people to understand better what their options are. Obviously that is not a magic bullet, but to some extent that would also help people budget better and perhaps save more.

Senator CARDIN. It is good advice. Financial literacy is one area where I think all of us can agree we have to do a much better job.

One of the real concerns about the decline of defined benefit plans is they are generally better managed than an individual's 401(k) or their own defined contribution plans. The automatic enrollment feature, we will see how that works. I am very encouraged but I think you are right, I think that will help a great deal in encouraging participation.

I would just emphasize that when an employer or the Government puts money on the table, individuals at all income levels are much more likely to take advantage of that. That is why anything we can do to encourage companies to provide pension plans for their employees is going to be helpful in increasing our savings rates.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Bunning.

Senator BUNNING. The timing is too good. Thank you, very much.

Chairman Bernanke, good to see you again. I congratulate you and the Fed in keeping interest rates where the American people can stand and the economy can prosper. I congratulate you, and that is not always the case.

Current account deficits and things about the budget, I am more concerned about out-years, as you have mentioned. I think we will see our deficits and our continuing income be at higher levels than we anticipated as far as revenues to the Treasury. And therefore, the reduction short-term in the deficit will be positive.

I am completely consumed by the fact that 2030, if we do not do something, that the three things called Social Security, Medicare, and Medicaid will consume the entire Federal budget. And therefore, we will not have a Defense Department, we will not have a Department of Labor, we will not have any other agencies of the Federal Government that can function.

Do you, in your wisdom, see some way that we can manage that?

Chairman BERNANKE. That is, of course, the question we are here to discuss. There are, for each of these programs, both revenue raising measures and ways of reducing expenditure. I would be happy to go over the list if you like.

Obviously though, as I said before, I do not want to pick and choose. I think it is up to Congress to make those tough decisions about—

Senator BUNNING. We are in need of help.

Chairman BERNANKE. Just to take an example, Social Security. The major options on the benefit side, I think, are first changing the indexing formula.

Senator BUNNING. The index as far as when a person can retire and the aging—

Chairman BERNANKE. No, I am referring Senator, to the way you calculate the initial benefit. Currently, the initial benefit is tied essentially to wages, which means that the replacement ratio, the share of wages, remains constant.

Senator BUNNING. I understand.

Chairman BERNANKE. The strongest measure, which was suggested by the recent Commission on Social Security, would be to switch to price indexing, which would keep the real value of the benefit constant but not the replacement ratio. That would solve the entire shortfall, as I understand.

A second measure would be something along the lines of what Robert Pozen has suggested, the progressive indexing measure, which would keep the—

Senator BUNNING. I think Chairman Greenspan also agreed with it.

Chairman BERNANKE. I am simply referring to some of the possible options here. That would keep the 30 percent lowest income people still indexed to wages, the very highest people indexed to prices, and those in between—

Senator BUNNING. Somewhere in the middle.

Chairman BERNANKE [continuing]. On a sliding scale between them. That would also close a fairly substantial part of the Social Security shortfall.

Increasing the retirement age gradually over time, particularly if you indexed the longevity subsequently—as life expectancies increased the retirement age would increase—would also reduce the long-term shortfall.

Senator BUNNING. On the same scale as we are doing now, from 65 to 67?

Chairman BERNANKE. Yes. So increasing the retirement age to 70 by 2029 would be another approach. Again, I am just listing possibilities.

We mentioned earlier the chain weighted CPI. You could use that to index the benefits after retirement. That would provide a slightly smaller rate of increase in benefits.

Senator BUNNING. How do we get around the promise that was made when people got into Social Security? How do you suggest that we tell the American people? Or do we set a date certain, say 20 years down the road, all those who got into Social Security at age 20 who are now 40, when they become 50 will have to get a different rate of return on their Social Security?

Chairman BERNANKE. Congress has made changes in benefits promises before. In the early years, the changes were mostly up. But in 1983, for example, following that commission, there were some changes down.

Senator BUNNING. We were going to go busted, so is was easier then.

Chairman BERNANKE. It is the same situation now; there are stresses on the system.

So just to be evenhanded, of course, the other side of the equation is payroll taxes. You could raise payroll rates under either the existing ceiling or you could raise the ceiling and the rates. So there are revenue side approaches, as well.

Senator BUNNING. We did that on Medicare and unfortunately that is one of the things that is not going to pay its way. We uncapped Medicare completely. And unless we raise the rate as far as the tax is concerned, we will not successfully change the policy of Medicare going busted earlier.

Chairman BERNANKE. That is right, Medicare is a much bigger problem than Social Security. And the Part A Trust Fund is 10 or 15 years away from insolvency, as I recall.

Senator BUNNING. That is correct.

Chairman BERNANKE. So anyway, Senator, I am just listing a number of the possible options one could take.

Senator BUNNING. Health care is another huge, huge problem that we are going to have to consider the fact that either we are going to have to lower benefits or share more of the cost with the employees and somehow pay the bill. The bill is getting to be a portion that we cannot pay federally.

Chairman BERNANKE. There is an enormous impending imbalance in Medicare. One way, if I may kill two birds with one stone, is to think about reform of the entire health care system. There are a lot of things that could be done, I think, to make the health care system more efficient and to control costs. That, obviously, would be good for the entire economy, as well as provide benefits for the fiscal budget as well.

Senator BUNNING. I think that is an answer, looking at the health care system in its entirety and making some new suggestions.

Thank you very much.

Chairman CONRAD. I thank the Senator. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Mr. Chairman. Welcome, Mr. Chairman, good to meet you.

You opened your testimony, sir, with the description of the deficit in the unified Federal budget as $248 billion. We had Comptroller General Walker here just recently and he put that into the context of a number of different figures. He identified the unified budget deficit of $248 billion. He identified the on-budget deficit, setting aside the Social Security cash offset, of $434 billion. He calculated a net operating cost on an accrual basis for financial reporting of a negative $450 billion. And our Chairman indicated another measure, which was that the national debt increased by $546 billion.

Among those four different measures of the fiscal slide that we are on, why is it that you picked the $248 billion number?

Chairman BERNANKE. Senator, first, one of the themes in my testimony was that we need to look at multiple measures to really get a full picture of the fiscal situation. So I did mention that number. But in the next sentence I mentioned the on-budget deficit, which you are correct, is about $434 billion.

You discussed the net operating costs, the accrual deficit, which is another interesting concept. I took it out of this draft for the following reason: the net operating cost which is now currently reported by the Department of the Treasury, which you correctly point out is $450 billion, adds to the deficit the accrual of obligations to pensions for Federal employees, as well as certain veterans' benefits.

But in a sense it is really an understatement because it makes no provision for the increased obligations under the entitlement programs.

The Governmental Accounting Standards Board is looking at ways to consider a net operating cost measure that actually includes, in addition, the obligations under entitlements. So as I mentioned at the end of my remarks, I think there are multiple measures to look at. The current deficit does say something about how much extra debt is being borrowed, how much extra debt is being issued to the general public, as opposed to the Trust Funds, for example.

But the present value of the unfunded liabilities of Social Security and Medicare is a very important number and is indicative of the long run imbalance that we face.

So what I was trying to argue is that to really understand this complex thing we call the Federal budget, you need to look at a number of measures. I would agree with what I think was implied by your question, that looking only at the unified Federal budget deficit, which is less than 2 percent of GDP, while of some interest for some purposes, tends to understate the severity of the fiscal problems that we face.

Senator WHITEHOUSE. That was precisely my point. I appreciate it.

Chairman BERNANKE. Including the entitlements.

Senator WHITEHOUSE. The other point I wanted to touch base with you on is, as Senator Sanders asked you about, the increasing gap between the rich and the poor. I understand that in your response to him you indicated that you would be speaking more to this shortly. I would like to request that if your remarks to be delivered shortly on this do not address certain topics, if you could get back to me on them.

It strikes me that there are secular causes related to the global economy for this shift. It is not that the rich have suddenly gotten smarter and more productive and the middle class has not. And so I would like to inquire of you what you think the secular forces are that are at work driving this gap? How bad it presently is compared to historical trends and norms? How urgent you feel it is that something be done about it? And what options that the Senate might engage in commend themselves to you?

Obviously, that is a 30 minute speech so please do not feel obliged to answer me now. But I do want to lay those down so that when your remarks come up, if they do not answer that, you can respond.

The last thing I would like to do is followup on what you said to Senator Bunning about the health care system. I could not agree with you more. I think our health care system is a nightmare. It is disastrous. And I think it would be a real tragedy if our Congress were to go out and reduce benefits and require people to pay more into this health care system without having taken the preliminary steps of doing our best to reform what is the most wasteful and extravagant system in the world.

And to the extent that you have folks at the Federal Reserve who are interested in working on that, I would love to be in touch with them, because I feel it is vital that we pursue this.

Chairman BERNANKE. Thank you, Senator.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

I would like to go back to the question of health care because everybody on this committee recognizes, this is the 800-pound guerrilla. If we do not make meaningful progress there, frankly all the rest of what we do is not going to address this problem meaningfully.

One of the things that I have tried to focus on is one statistic that I find especially powerful. Roughly 5 percent of Medicare beneficiaries use half the money. Five percent use one-half of the budget. They are, of course, the chronically ill. They have multiple serious conditions.

We did a study with about 20,000 patients, I think it was 21,000 patients. We put a case manager on every one of their cases to better coordinate their care. The first thing they did was go into their homes and get out all of the prescription drugs they were taking. On average, they found they were taking 16 prescription drugs. And after review, they were able to cut that in half.

As a result of that effort and the others that were made to better coordinate their care, with this group they cut hospitalization 50 percent. As a result, there were very dramatic financial savings but there were also better health care outcomes. People were healthier.

I did this with my own father-in-law in his final illness. We went and got all of the prescription drugs out of the table, and he was taking 16. I got on the phone to the doctor and went down the list. About the third one the doctor said to me my god, Kent, he should not be taking that. He should not have been taking that the last 3 years. A little further down the list, two drugs he was taking, the doctor said Kent, those two drugs work against each other. You should never be taking them together.

I said doctor, how does this happen? It was very simple. He said he has four different doctors. He has a heart specialist, he has a lung specialist, he has an orthopedic specialist, he has me as his family practice doctor. All of them prescribing for him, none of them know what the other one is doing. He said he is getting prescription drugs from the hospital pharmacy, he is getting them from the corner pharmacy, he is getting them from the pharmacy at the beach, he is getting them mail order. He is sick and confused. His wife is sick and confused. And we have nobody, in effect, managing the case.

He said I am supposed to be. I am his family practice doctor. But I do not know what the heart doctor has prescribed. I do not know what the lung doctor has prescribed. And of course, it is even more complicated than that because it was not just one heart doctor. There were three heart doctors. It wasn't one lung doctor, there were several.

Is this something you have looked at at all in terms of focus? Does it make sense to you that we further pursue this? What reaction might you give to this basic concept, that we have a small percentage of the population that is using most of the money?

Chairman BERNANKE. Senator, first, you have identified some important issues. It is the case, because of the conditions you referred to, that a large part of the money is used by a relatively small share of the population.

I think the approach that this cries out for is what you might call integrated health care management, in which the health care of an individual is coordinated, their prescription drugs are coordinated, there is an overall evaluation in what that person is doing.

From a policy perspective, though, there are some interesting questions about how best to achieve that. Let me give you three models. One model, which applies at least to some people, would be sort of consumer-directed, which says people are primarily responsible for themselves and their families. For people who are competent—who are not that ill or are relatively well-educated and so on—perhaps self-responsibility may be the right approach.

For those who need more extensive management from professionals, there are two models. In one Government provides money but the patient chooses from a set of providers, HMOs or PPOs or other private-sector providers, whose profitability depends on their ability to manage the entire health care situation, including preventive care and so on.

The last model is a Government provision system where again, if the Government is providing, it is important that there be serious attempts to make sure that provision is as efficient as possible. The kinds of things you are talking about, a caseworker or an integrated approach, would be important in that context, as well.

Chairman CONRAD. Would it not be important that we have better case management, whatever model we adopt? That somehow, we have, especially with this chronically ill population, which tends to be older people with multiple serious conditions, somehow—although our health care system is exceptional in so many ways.

You know, my grandfather was a doctor. He was the medical chief of staff of our hometown hospital. When people are ill in other countries, where do they want to go? They want to come here.

It is also true we have by far the most costly health care. We here at 16 percent of gross domestic product now in health care. I think the next highest country is 11 percent. And that delta, that difference between 16 percent of GDP and 11 percent is $800 billion.

So it would seem to me that whatever system we adopt, providing better case management is part of a more effective health care system. Does that strike you as accurate?

Chairman BERNANKE. Yes. I might add that I think a very important element of that would be improving our health IT, information technology, system which I know is currently, to some extent, underway. But if a doctor could look online and see what prescriptions the patient already has and what their previous conditions were and so on, that would eliminate some of the problems that you are talking about.

Chairman CONRAD. You know, I just held a health information technology summit in my State, with all of the major health care providers. One of the ideas that was presented there was a health passport, if you will. It would be a record that somebody could have with them. It also be online at their doctors, that would have in a computer record all of the contacts with medical professionals.

So that heart doctor would know what the lung doctor prescribed. The family practice doctor would know what the other doctors had prescribed. And not only meds that were prescribed but also tests that were given. I know my stepfather had, I think, three MRIs in the last year of his life, from three different sources. This is the kind of thing that really does explode cost without improving health care. In fact, it probably makes health care, certainly the comfort of the patient less.

Let me ask one final question and that is the matter of the tax gap. We have not talked about that today. The Internal Revenue Service Commissioner came before this committee and testified the tax gap is now somewhere in the range of $350 billion a year, and that is based on an estimate. I happen to believe it is a conservative estimate, given how that estimate was arrived at.

So if our tax system at current rates was generating the revenue intended, we would not have a deficit. The deficit would be eliminated.

Any thoughts you have on this tax gap, the difference between what is owed and what is being paid? How we could better capture that revenue without a tax increase or a rate increase?

Chairman BERNANKE. Senator, I agree that is a very important issue. You are never going to get 100 percent compliance but you could get better compliance. I think it is important not only for the revenue, as you mentioned, but also because our system is very much based on self-enforcement. People turn in their tax returns because they are basically honest and they think other people are doing it as well. If people have the sense that lots of people are cheating the system and are not paying their fair share, then they are going to be less willing themselves to pay their taxes.

How to increase collection is a difficult issue. Let me raise one possibility that might be worth exploring. In the United Kingdom there is currently a paperless return system where it is possible, essentially through what is the equivalent of W–2 forms or withholding at the employer-level integrated with other types of income, that the tax obligation of the worker could be calculated essentially automatically, and there is no need for a form because there is no refund. Basically it is an exact measure. So it is a method of essentially automatic deduction. That would be one approach.

Otherwise, it is difficult to say. I think some of the areas where the tax gap is larger, maybe small business and some others, pose some difficult problems in terms of collecting. People who have off-the-books income, things of that sort, so there are some difficult issues there. I do not think I have any really great suggestions.

But to the extent that we can increase compliance, it would be good for the system as well as good for the revenue.

Chairman CONRAD. Do you think we ought to consider tax reform as part of an overall effort here? One of the things that strikes me is we have a tax system that was largely devised in the 1930's, 1940's, 1950's, and we have a world that is fundamentally changed.

One thing that has struck me is maybe we need to have, as one part of a strategy, a really thorough review of our tax structure and system, tax reform that could make collections more efficient, more effective. And at the same time, strongly consider our economic position in the world and our competitive position in the world, because I am more and more convinced, as a member of the Finance Committee, that we really do not have a system that maximizes our competitive position.

Chairman BERNANKE. I think there is a good case for looking at alternatives. We have a number of problems now, including the complexity of the system, the Alternative Minimum Tax, what are we going to do about that, and so on.

I will say something that I hope will be uncontroversial, which is that the current tax code is very burdensome. Some estimates a few years ago suggested that the average taxpayer spends 27 hours on their taxes every year and that the total cost of compliance, including the hours spent, is over $110 billion a year. You could think of that as part of the tax gap as well. If that cost could be reduced, you would be saving the economy a significant amount of money and perhaps making people more willing and able to comply with the law.

Chairman CONRAD. Senator Gregg.

Senator GREGG. I am interested to know why you think the markets do not factor in, it appears, the implications of the numbers which you have talked about here in the out-years relative to long-term debt? If I was buying long-term debt 10, 15, 20, 30 years out, I would sure want a much higher interest rate than what appears to be what the markets are demanding today. What are they assuming we are going to do that I am not aware of?

Chairman BERNANKE. Senator, I think my predecessor commented also on this puzzle. Thirty-year bonds are paying interest rates not much more than 5-year bonds.

Evidently either this is a trading phenomenon and the holders of the bonds are not really thinking about 30 years in the future, or, the other possibility, is that one way or another the bondholders do expect that Congress will take whatever measures are needed to ensure that the bonds are paid off and that it is done in the context of price stability.

Senator GREGG. Which gets me to my second point which you alluded to, price stability. One way that this has been handled in other economies has been to inflate the economy. How do we avoid that?

Chairman BERNANKE. The Federal Reserve is independent and the Federal Reserve will follow its mandate and ensure that prices remain stable.

Senator GREGG. That is comforting.

Chairman BERNANKE. Thank you.

Senator GREGG. On the issue of tax reform, do you believe a consumption tax is a vehicle that we should be looking at? And if you do, how do you avoid the inherent problems which come from putting that sort of an engine on the government and causing the government to just explode in size?

I come from a State that has neither a sales or an income tax. We look at our neighbors in Vermont and Massachusetts, where our neighbors were told that if they just put in a sales tax their income taxes would go down. What they found is that their government just got a heck of a lot bigger and their income taxes stabilized for a few years and then started going back up.

Chairman BERNANKE. Senator, as you know, I cannot really endorse a particular approach. But I will say a word about feasibility, which is that consumption taxes can be implemented lots of different ways. One way is through a value-added tax, which a lot of European countries use. Another way is through a retail sales tax. A third way would be through a saving exemption approach where you look at your income at the end of the year and you document how much you have saved and that part is deductible. That essentially becomes a consumption tax.

So there are a number of ways to move toward a consumption tax, and so I do not think the feasibility is really the issue. I think the issue is whether it produce a more efficient economy. In addition, since wealth is unequally distributed and the higher income people are much more likely to have capital income, could we structure a comsumption tax in such a way as to maintain the degree of progressivity that we would like to see in the tax system?

Senator GREGG. Of course, the response to that is that wealthy people buy a lot more, so they would pay a lot more in taxes if you had a consumption tax.

But in any event, thank you for your answers. Thank you for being here today. I especially appreciate your opening statement. I think it was absolutely correct, right on, and a clarion call that I hope some folks will listen to. We are certainly going to try to be an echo chamber for you.

Chairman BERNANKE. Thank you for the opportunity.

Chairman CONRAD. Senator Bunning has a followup.

Senator BUNNING. I just want to find out if somebody has questioned you about PAYGO? Has anybody here questioned you?

Chairman BERNANKE. No, sir.

Senator BUNNING. The Senate PAYGO point of order has existed in some form since 1993. The PAYGO point of order currently in place stems from the 2004 budget resolution and makes it out of order to consider legislation that would increase the deficit by more than the amount of the deficit increase, if any, assumed in the most recent adopted budget resolution.

From 1990 to 2002, under statutory PAYGO, any deficit increases that were enacted were added together and put on PAYGO scorecards. At the end of the year any balance on the scorecard were supposed to be reduced by a sequestration. However, no sequestration has ever occurred, despite large PAYGO balances.

The original purpose of this mechanism was to encourage Congress and the president to only enact changes to mandatory spending and revenues which were offset so as not to increase the deficit.

Question: do you think that PAYGO point of order is an effective budget enforcement tool? Or does it merely exist to replicate other budget enforcement tools that already exist?

Chairman BERNANKE. Senator, these parliamentary rules that have been set up to try to address deficits are very complex. And as you point out, their efficacy depends on a lot of things, including how willing the membership is to following through. I do not really have the expertise to advise on the types of rules, PAYGO and others, for addressing budget issues.

I think the comment I would like to make is one that I made in my opening remarks, which is that I do think, from an economic perspective, that it is useful not to focus too much on a single measure of fiscal stability but to look at a number of different measures including, for example, the share of total spending in the economy and, very importantly, given the discussion we have had today, the long-run solvency of the entitlement programs.

Senator BUNNING. Thank you very much, Mr. Chairman. Thank you, Chairman Bernanke.

Senator CONRAD. Thank you, Senator.

Again, Mr. Chairman, thank you very much. We promised to get you out of here by noon. We will be good to our word and get you out even a little earlier.

We very much appreciate the constructive testimony you have provided here. And we hope people are listening about the need for us to address these long-term imbalances, to take these challenges on, and the sooner we do so the better.

Thank you, sir.

[Whereupon, at 11:50 a.m., the hearing was concluded.]

<u>Opening Statement of Senator Allard at the Hearing of the Senate Budget Committee on Long-Term Economic and Budget Challenges</u>

The Honorable Ben Bernanke
January 18, 2007

The tax cuts passed by the Republican Congress and signed into law by President Bush are working to stimulate our economy, increase revenues, and reduce deficits. Since 2003, revenues have rebounded sharply following several years of decline. Last year, revenues were up almost 12 percent to $2.4 trillion, the highest in our Nation's history. Consequently, the budget deficit has been cut in half, several years ahead of the President's goal. This fiscal year is already off to a strong start with revenues up 8% for the first quarter of FY 2007, including a $40 billion budget surplus in the month of December.

While we are making progress in the right direction on the revenue side, looming on the horizon is the potential for a crisis on the spending side of the budget equation. I am talking about long-term entitlement spending. If the rate of growth is left unchecked, spending on just three entitlement programs – Social Security, Medicare and Medicaid – will exceed the historical amount of all federal spending as a percentage of GDP by 2030. In other words, those three programs will cost as much as the entire federal government has historically cost the American people—including things like national defense and education.

Clearly, this level of growth is unsustainable and threatens the economic well being of not only our generation, but also our children and grandchildren. It is our responsibility as a Congress to ensure the solvency of these entitlement programs. I admit that there is no easy answer; any solution will require us as a Congress to make tough decisions. I am grateful to have Chairman Bernanke here before the Budget Committee today to share his thoughts on the issue and how this Congress might go about addressing it in a thoughtful, deliberate, and effective manner.

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

BEN S. BERNANKE
CHAIRMAN

January 26, 2007

The Honorable Frank R. Lautenberg
United States Senate
Washington, D.C. 20510

Dear Senator:

I am pleased to enclose my response to the question you submitted following the January 18 hearing before the Committee on the Budget. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to a written question received from Senator Frank R. Lautenberg in connection with the January 18, 2007, hearing before the Committee on the Budget:

The tax gap, which was estimated by the Internal Revenue Service (IRS) to be $290 billion in Fiscal Year 2001 after IRS enforcement efforts, is a significant amount of potential government revenues. Given that closing the tax gap would reduce the deficit significantly, do you think the IRS is adequately staffed to perform their enforcement duty?

The tax gap raises many difficult and important policy issues. Let me comment on a few points the Congress may wish to consider.

All else equal, of course, greater tax compliance is to be preferred not only for the additional revenue that it can generate but also as a mechanism for sustaining compliance over time. Our system depends critically on self-enforcement. Most taxpayers file complete and accurate tax returns because they are honest and they think other people are filing honestly as well. If, however, taxpayers come to believe that cheating is rampant, voluntary compliance will decline. Clearly, such a development would be harmful to our common national goals. Devoting additional resources to enforcement could help reduce the chances of a turn in this direction.

At the same time, though, increased enforcement activity could also impose significant compliance costs, a substantial fraction of which might well fall on honest taxpayers who are already paying their fair share.

Determining the appropriate level of enforcement resources for the IRS requires striking a balance between these benefits and costs. In striking that balance, the Congress may wish to consider a variety of factors, including competing federal funding priorities; the likely efficiency with which the IRS would be able to target additional enforcement resources on non-compliant taxpayers and avoid imposing additional costs on compliant ones; and the possible implications of stepped-up enforcement for the taxpayer-service side of the IRS's operations. Achieving the right balance between the costs and benefits of greater enforcement is an important and sensitive ongoing responsibility of the elected representatives of the people. The Federal Reserve has no specific expertise in that area.

THE GROWING TAX GAP AND STRATEGIES FOR REDUCING IT

TUESDAY, JANUARY 23, 2007

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, Wyden, Stabenow, Menendez, Lautenberg, Cardin, Sanders, Whitehouse, Gregg, Grassley, Allard, and Crapo.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

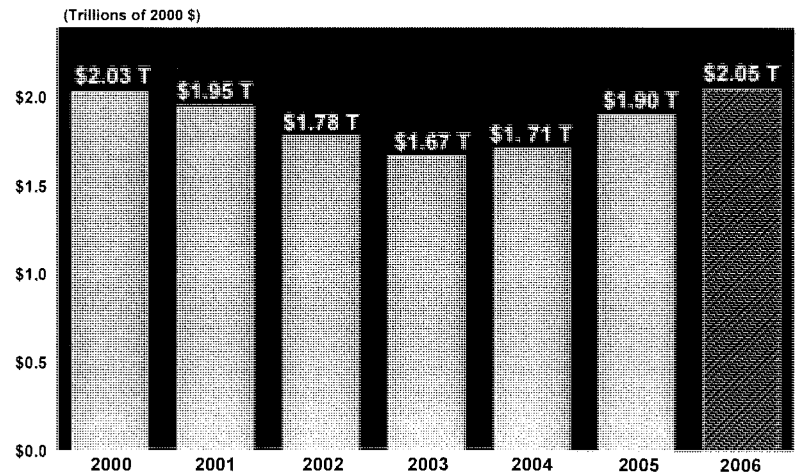
OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. The committee will come to order.

I want to thank members of their participation today. I want to especially thank the panel that we have, really three excellent witnesses. Robert McIntyre, the Director of Citizens for Tax Justice, good to see you again. Michael Brostek, the Director of Tax Issues for the Strategic Issues Team of the Government Accountability Office, the GAO. John Satagaj from the Small Business Tax Compliance and Fairness coalition, welcome. Good to have you here, as well.

The hearing this morning is about the growing tax gap and strategies for reducing it. The tax gap, as we all know, is the difference between what is owed and what is actually being paid. And we now know that, according to the Revenue Service, the tax gap is running at about $350 billion a year. Let me repeat that. The tax gap is estimated by the Revenue Service to be $350 billion a year.

Real Revenues Have Experienced Virtually No Growth Since 2000



Source: OMB, CBO
Note: 2006 estimate using deflator from President's budget, FY 2007

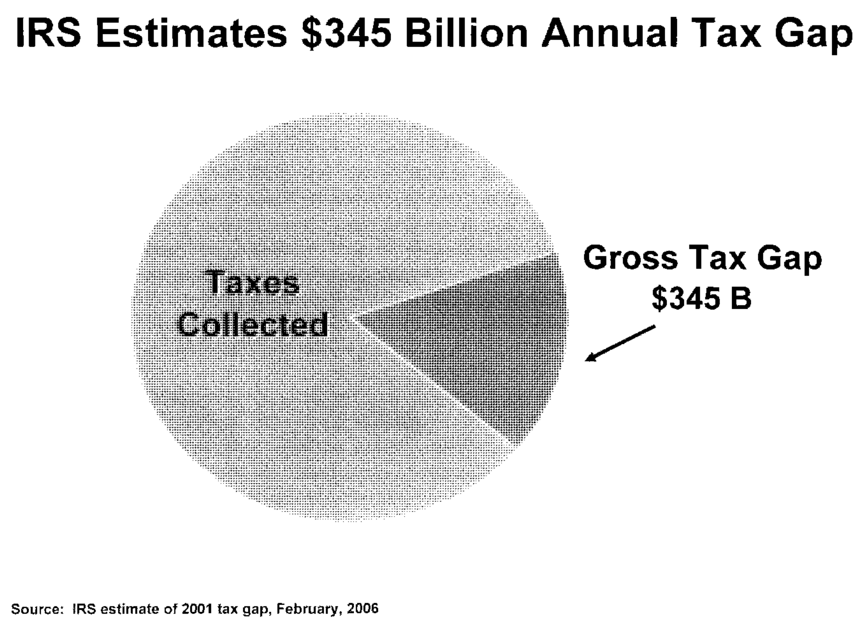
That is money that should be in the coffers of the Federal Government, according to existing tax law. We are not talking about a tax increase here. We are not talking about increasing any rate. We are talking about collecting the money that is due and owed under the current law.

The tax gap, I believe, is unfair to the vast majority of taxpayers who pay what they owe. We know that the vast majority of Americans do pay their taxes. The vast majority of companies pay what they owe. But we have a growing number of both individuals and companies that do not.

Unfortunately, our Nation's budget picture is not good. As we see on the chart, last year the deficit was $248 billion but the debt rose by $546 billion.

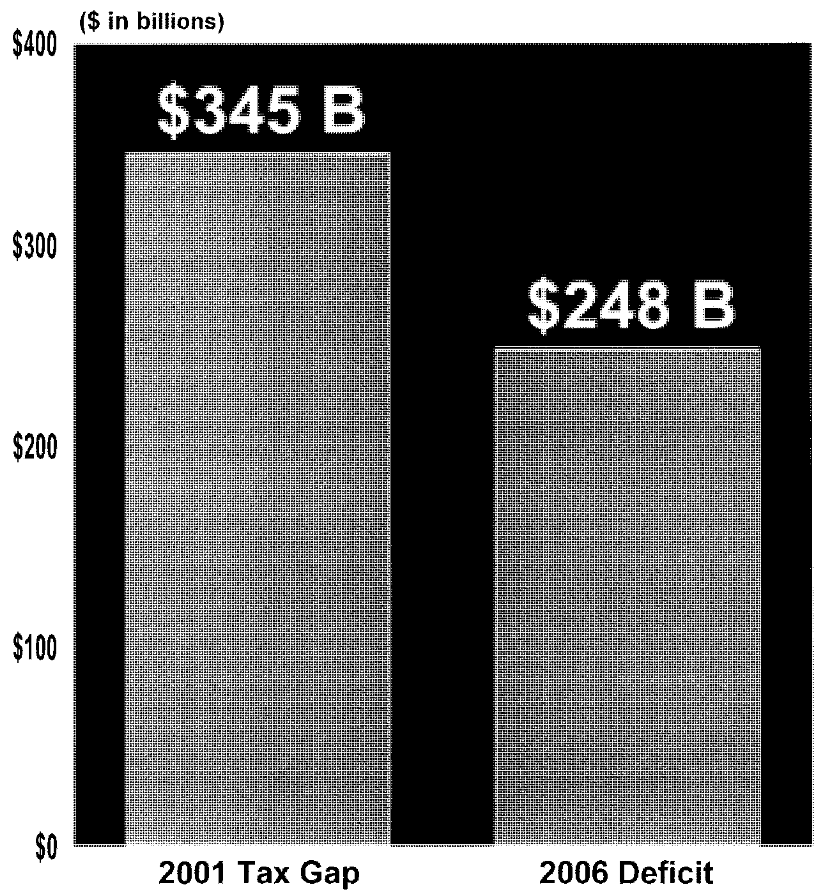
While increased spending has contributed to the deficit and debt, the dramatic decline in revenues has been an even larger factor. In fact, real revenues—that is adjusted for inflation—have experienced little growth since 2000, as we see in this chart. It is true, and my colleague will perhaps reference, that the last several years we have seen healthy growth in revenues. But if we go back to 2000, we see that we are only now getting back to the revenue base we had then.

That brings us to our hearing today on the tax gap. The growth of the tax gap is one of the factors contributing to the revenue drop. According to the IRS's latest estimate, the tax gap in 2001 was $345 billion for that year alone. To put a $345 billion tax gap in some perspective, considered that it is almost $100 billion larger than the size of the entire deficit in 2006.



While we will never be able to close the tax gap entirely—and make no mistake, we understand we are not going to collect all $345 billion a year, there is always going to be some tax gap—but it is clear that much more can and should be done.

Size of Tax Gap Compared to Size of Projected Deficit in 2006



Source: IRS, CBO

In testimony before this committee, the IRS Commissioner stated "You can clearly reduce the tax gap $50 billion to $100 billion a year without changing the way the Government interacts with its citizenry." In other words, we can close a considerable amount of the gap without resorting to draconian or intrusive measures.

IRS Commissioner Says Tax Gap Can Be Reduced $50-100 Billion

"...[Y]ou can clearly reduce [the tax gap] by $50 or $100 billion, without changing the way the government interacts with its citizenry."

– IRS Commissioner Mark Everson
Testimony before Senate Budget Committee
February 15, 2006

It is important to remember that the added burden placed on taxpayers from the tax gap is very real. In her 2006 annual report to Congress, the National Taxpayer Advocate wrote, and I quote, "Compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. Each household was effectively assessed an average surtax of about $2,680 to subsidize noncompliance in 2001. That is not a burden we should expect our Nation's taxpayers to bear lightly."

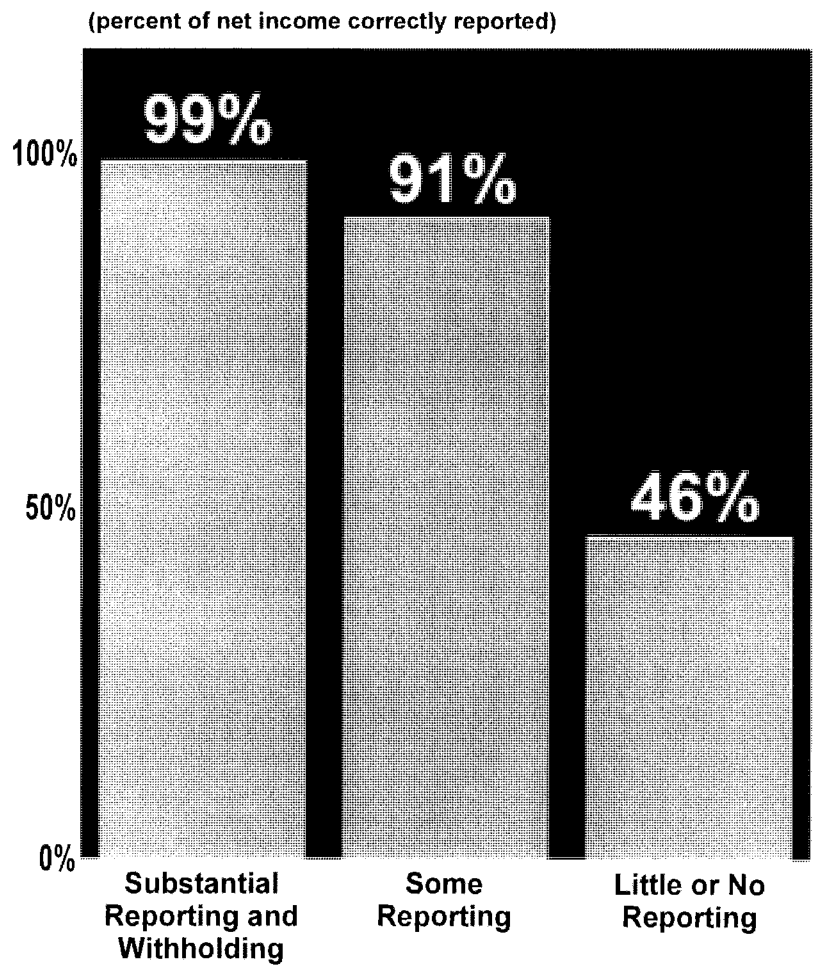
National Taxpayer Advocate Finds Tax Gap Adding More Than $2,000 to Average Household Tax Bill

"Compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. ... [E]ach household was effectively assessed an average 'surtax' of about $2,680 to subsidize noncompliance [in 2001]. That is not a burden we should expect our nation's taxpayers to bear lightly."

–National Taxpayer Advocate Nina E. Olson
2006 Annual Report to Congress
January 9, 2007

To close the tax gap, we need to enhance reporting and withholding requirements for certain taxpayers. We know that taxpayer compliance improves dramatically with increased reporting and withholding. For example, according to the revenue service, for income that is subject to substantial reporting and withholding requirements such as wages and salaries, we see a 99 percent compliance rate. When reporting requirements are in place we see a 91 percent compliance rate. But when there is neither, we see a sharp drop in the compliance rate, falling to less than 50 percent.

Taxpayer Compliance Improves Dramatically with Increased Reporting and Withholding



Source: GAO, IRS

The other way to close the tax gap is through better enforcement by the IRS. In his testimony before the Budget Committee last year, the IRS Commissioner noted that the IRS yields approximately $4 in revenue for every additional dollar spent on enforcement. We simply cannot bring the budget back to balance by looking only at spending, although he must certainly do that.

IRS Commissioner Everson Projects 4-to1 Return on IRS Enforcement

"The IRS yields approximately four dollars in direct revenue for every additional dollar spent in its enforcement efforts."

– IRS Commissioner Mark Everson
Testimony before Senate Budget Committee
February 15, 2006

In my judgment, we cannot do it solely on the spending side even with entitlement reform which is absolutely required. There is also going to have to be additional revenue. And I would strongly prefer that instead of talking about tax increases, that before we start talking about tax increases for anyone, we aggressively go after this tax gap. It is only fair and, I think, right.

With that, I turn to my colleague, Senator Gregg.

OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Thank you, Mr. Chairman, and I want to congratulate you. These first series of hearings that you have held have really been right on and they have been addressing issues which are critical to our Nation's economic health and social health and our cultural health. This is another one in that series and I thank you for holding this hearing.

This has been an issue that you have talked about a lot over the years. And in response actually to your concerns in the last budget which we put together—which you regrettably did not vote for, and I cannot understand why—we did put in the reserve fund in order to fund the IRS to assist them in collecting more money to get some of those revenues back that you have reflected in your statements.

And so I am in total agreement that this is a critical area of need.

I would also like to cite the fact that I do disagree with your characterization of revenues as they are presently coming in. I want to congratulate the former chairman of the Finance Committee who is with us today and a member of this committee, for having put in place a tax law which has allowed us to generate massive increase in revenues as a result of economic activity in this country.

Over the last 3 years, we have seen some of the biggest revenue growths in the history of the Nation. Historically the Federal Government has taken 18.2 percent of the Gross National Product in revenue. We are now over that number. We are up to about 18.5 percent of Gross National Product. So we are generating more revenues than we have historically generated. Obviously, not enough to close the gap because spending is above where it should be.

But in addition, the tax laws under the leadership of Senator Grassley have become more progressive. The top 20 percent of American taxpayers today on the income tax side bear about 85 percent of the tax burden. Under the Clinton years they bore about 82 percent of the tax burden. The bottom 40 percent of income earners in this country today do not pay taxes but they receive income back under the Earned Income Tax Credit and other benefits which actually is double what they received during the years of the Clinton Administration.

So we actually have a more progressive system while generating more revenues. That is the good news. I think it is because we have incentivized the market. We have said that we are going to say to people who are job creators, we are going to give you an incentive to go and create jobs by being more productive by having a reasonable tax rate on capital formation.

Obviously a difference of opinion there, but I believe—I wanted to make the point that I wanted to make relative to the fact that revenues are up.

But they could be up further through the collection of taxes that are presently owed. That brings us to this hearing. It is an issue which is a difficult issue. We can increase IRS support and the IRS, in return for that, says they can get us more revenues, maybe somewhere between $50 billion and $100 billion can be collected simply by having a more aggressive stance from the Internal Revenue Service and giving them the funds to accomplish that.

But that does not really get to the underlying issue which is the tax gap that is over $350 billion or in that range, which is a big number. And that really comes back to the structure of the tax laws itself, in my humble opinion. We have a tax law that is incredibly complex, massive in size, nobody understands it. After finishing law school I went back to school for 3 years and got a graduate degree in tax policy and taxation, and I do not do my own taxes because it is too complex. It is just not a system that encourages efficiency.

A lot of this failure to comply is not intentional. It is simply that the laws are so complex. Some of it is intentional, obviously, there is an underground economy. But a lot of it is just simply that the law is so complex.

So we need to take another look at our tax structure and come up with something that is more manageable, more understandable, and therefore more enforceable. I think the Chairman has pointed out that when you have an enforcement mechanism which is easily put in place, such as a payroll tax deduction, you get a high percentage of compliance. But when you do not have that enforcement mechanism because you have an economy that is outside of that capacity to collect, you do not get the percentage of participation you should.

So I think we need to look at tax systems which will allow us to get a better percentage of return for taxes that are owed. And that is something I hope we will discuss in this hearing.

But in any event, I certainly appreciate the Senator holding this hearing and I look forward to hearing from our witnesses.

Chairman CONRAD. Thank you, Senator.

We will go to the witnesses now. Mr. McIntyre, welcome. It is good to have you before the committee once again. Please proceed.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you.

Senator Conrad and members of the Budget Committee, I am Bob McIntyre and I direct Citizens for Tax Justice, which is a tax policy and research group that fights for a fair tax system for middle income families all over the country, Federal, State and local. I have been doing this for 30 years.

Today we are talking about something that is an important piece of our tax puzzle, and that is the fact that we are not collecting taxes from a lot of people who should be paying them. You can look, as Senator Conrad pointed out at how serious our budget deficit problem is, how much we have been borrowing. In fact, over the last 5 years we have funded 25 percent of our Federal budget outside of Social Security with borrowed money, which is just staggering. And that was after balanced budgets in the years before that.

We know why that has happened. Income tax revenues have gone through the floor. They were more than 10 percent of the GDP in fiscal 2000. They have averaged 7.3 percent over the last 5 years, which is a 28 percent drop.

Now we have had a minor improvement lately. Income taxes are only 25 percent below where they were in fiscal 2000. That is the problem. Now we are not going to solve that problem while George Bush is president because he would veto any attempt to repeal his tax cuts. We know that.

But Republicans and Democrats and President Bush, a Republican, must be able to agree that ought to collect the taxes that are due, that people who are cheating on their taxes should not be allowed to do so. If we cannot agree on that, well, my.

So what can we do? Let us talk about the tax gap, the nature of it. The IRS has a figure. It is not a very reliable figure. It is based on very old data or very incomplete research. They say the net figure is about $300 billion after they have collected $50 billion or so from catching people.

But it is bigger than that, in my view, because they do not count all of this offshore tax dodging because they do not know about it. They do not count all of these corporate tax sheltering deals because they do not know about them or do not know enough about them to measure. So it is really an even bigger figure than that.

Those are the things that are doing the most damage right now to our tax system, in my view. And that is what my written testimony focuses on, and that is what I want to focus on in my few minutes today.

As Senator Conrad pointed out, we have a country of honest wage earners. They pay their taxes. Maybe not because they are morally superior but maybe because their income is known to the IRS. There is information reporting, there is withholding, and that works.

But when you get to the kinds of income that the IRS does not know about, whether it is capital gains or business profits that there is no paper trail that goes to the IRS, then we have a problem. The people who have these kinds of income are not all a bunch of crooks. Some are. But they all need help. They need our help to pay their taxes honestly and be good patriotic Americans, like I am sure they all want to be.

So how can we help them? Well, we need to get rid of the secrecy as much as possible so that there is a paper trail to the IRS, so that the IRS knows about these kinds of income. You can do some of it with 1099s. You can do some of it with agreements with other countries, which is a huge problem, so we get information from them. We have a long list in our testimony of proposals that get into that area.

We also need to clarify the law. We have laws against most of these offshore tax cheating activities. But arguably they are not completely clear. And if you are a lawyer, everything is arguable. I went to law school, too.

We need to make it completely clear so that people do not have a leg to stand on when they get into these deals. That means that the people who are advising them, the lawyers, the accountants, the investment bankers, will be in serious trouble if they help them out in these schemes. So clarification is a good thing.

Penalties would also be a good thing. I know we have been increasing penalties. They are obviously not high enough because the chances of being caught are so low. Penalties on the advisers, even more penalties, would be a good idea.

Finally, we need to give the IRS the resources it needs. The IRS has been cut back and cut back, so now the number of people who are devoted to examinations are down by almost one-third since 10 years ago. That is a huge problem.

Let me just say that this may sound easy and I am implying it is easy, that everybody ought to agree. But there is a lobby that does not agree and they have a lot of power. You could argue that the House Ways and Means Committee for the past 6 years has been a wholly owned subsidiary of the major accounting firms. Every attempt by the Senate to crack down on cheating has been resisted in the House up until now. I do not think that is going to be the case anymore.

But there is an organized Tax Cheaters Lobby. It is financed by the banks, the accounting firms, and the lawyers who offer this kind of advice. They have front groups. One of them is called the Center for Freedom and Prosperity, a grandiose title. But I prefer to call them all Tax Cheaters Lobby because that is more intelligible.

Fortunately, there are a lot of people, in the Senate, in particular, who have been leading the fight in the other direction, and that is the good news. Carl Levin and Norm Coleman over at the Investigations Subcommittee. Byron Dorgan, your colleague from North Dakota who has been fighting against corporate and offshore cheating since he came to Congress. Senator Grassley, who as Senate Finance Committee Chairman has helped exposed some of these terrible abuses, and proposed legislation—and occasionally adopted legislation—to try to crack down on it.

So these are the people you should be looking to once you give them the mandate do something about it.

In my testimony, I have a lot of details about going after offshore tax evasion.

There are a lot of little things you can do and there are two big ones. One big one is to get the tax haven countries to disclose what is going on with our citizens. The only way you are going to do that is to have pressure on them so that, for example, if they do not disclose, our banks cannot talk to them, cannot send any money to them. They are out. They have to disclose.

The Cayman Islands, by the way, is worried about that enough that it is starting to think about giving us some serious disclosure. The problem in the world is if you have just one tax haven country, you are up the creek because that is where the money will go. So we need to go after them all. And we need to get the European countries to work with us on this. They are dying to do it because they have the same problem we do.

We see some of our celebrities moving their money offshore. The Levin-Coleman hearings found three people that were moving billions of dollars offshore. Well, the British have the same problem. The Rolling Stones and Bono have moved their song writing royalties to the Netherlands, which does not tax royalties. Their tax rate on billions of pounds has been 2 percent. So we need to work with the rest of the world on this.

I see my time is up but finally, the IRS. If you could phase in a doubling of their enforcement budget over the next five or 6 years, the returns would be enormous and it would get us back on the right path.

Maybe you need to change the budget rules. After all, if the IRS was treated like any other agency, it would have offsetting receipts. OK, we spent $11 billion, our offsetting receipts were $2.2 trillion—do you see what I am saying?

Why do they not get treated that way? The National Park Service gets to count the fees for going in to the parks? The National Taxpayer Advocate has suggested something along these lines. Really, it is kind of wacky that you should freeze the IRS budget when it costs you 10 times or 15 times what every budget cut that you put in saves.

So those are my recommendations. I have a long piece of written testimony and I thank you for the opportunity to be here. And I am sorry I went over a minute.

[The prepared statement of Mr. McIntyre follows:]

Citizens for Tax Justice • 1616 P Street, NW, Washington, DC • 202-299-1066 • www.ctj.org

Statement of Robert S. McIntyre
Director, Citizens for Tax Justice
Before the Senate Budget Committee
January 23, 2007

I'm Robert McIntyre, director of Citizens for Tax Justice. Founded in 1979, CTJ is a nonprofit tax policy research and advocacy group that fights for fair and adequate taxes at the federal, state and local levels. I appreciate the opportunity to appear before the Budget Committee today, to discuss the federal "tax gap" — a polite word for tax cheating that is costing honest taxpayers hundreds of billions of dollars every year.

One impetus for this hearing, I assume, is the need to address our government's huge budget deficits. From fiscal 2002 through 2006, on-budget federal deficits totaled $2.4 trillion, including $836 billion borrowed from the Social Security Trust Fund and spent on other government programs. Over those five years, a staggering 25 percent of all non-Social Security outlays were financed with borrowed money.

Non-Social Security Receipts & Spending, Fiscal 2000 to Fiscal 2006

$-billions Fiscal years	On-budget Receipts	On-budget Spending	Deficit (–) or Surplus (+)	% of spending paid for with borrowing
2000	$ 1,545	$ 1,458	$ +87	*none*
2001	1,548	1,516	+32	*none*
2002	1,272	1,654	–381	23.1%
2003	1,265	1,794	–529	29.5%
2004	1,345	1,913	–568	29.7%
2005	1,569	2,071	–501	24.2%
2006	1,798	2,232	–434	19.4%
2002-06			$ –2,414	25.0%
Addendum: Social Security (off-budget)				
	Receipts	Spending	Surplus	
2000	$ 480	$ 330	$ +150	
2001	508	347	+161	
2002	515	357	+158	
2003	524	363	+161	
2004	535	380	+155	
2005	577	402	+175	
2006	608	422	+186	
2002-06			$ +836	

Sources U.S. Treasury Department (compiled by Citizens for Tax Justice).

The largest cause of these enormous deficits has been the remarkable drop in personal income taxes, which fell from 10.1 percent of the gross domestic product in fiscal 2000 to an average of only 7.3 percent of the GDP in fiscal 2002 through 2006 — a 28 percent drop. In fact, income tax revenues have been at or near their lowest levels as a share of the GDP in 55 years. Obviously, this sharp decline in personal income tax revenues stems mostly from the huge tax cuts enacted during the Bush administration. Equally obviously, President Bush will block any attempt to scale back his tax cut program so long as he remains in the White House.

Personal Income Taxes*

Fiscal Years	$-billion	% of GDP	Versus 2000	Rank** 1952 on
2000	$ 978.4	10.1%	—	1
2001	967.2	9.6%	–5%	2
2002	825.5	7.9%	–21%	26
2003	755.3	7.0%	–31%	54
2004	767.0	6.6%	–34%	55
2005	878.0	7.1%	–29%	52
2006	991.9	7.6%	–25%	44
Addendum: 2002-06 average		7.3%	–28%	

*Personal income taxes net of refundable credits.
**55 is lowest year. (1965 was 53rd.)

Sources: Office of Management and Budget; U.S. Treasury Department; Congressional Budget Office.

But there is a way to begin to address our revenue shortfall that perhaps Democrats and Republicans can agree upon: collect taxes that are legally due, but that go unpaid due to tax evasion and abusive avoidance.

The Nature of the Tax Gap

The IRS offers a measure of the tax gap, which pegs it at around $300 billion annually. But that measure is largely based on old or limited research, and thus leaves out some of the most important things. In particular, it only touches on the widespread tax evasion and avoidance by corporations and wealthy individuals — often using offshore tax-sheltering schemes. It's that part of the tax gap that I want to focus on particularly in my testimony today. (A 2005 paper that goes into the background of these issues at greater length is available on our web site at www.ctj.org/pdf/epishel.pdf.)

When it comes to paying taxes, wage-earners, as we know, are generally very honest. That's not because of any inherent moral superiority, but rather because income and employment taxes are collected or withheld as wages are earned. Compliance is also quite good in the case of interest and dividends, because of information reporting. In contrast, those who earn other kinds of non-wage income or have the means to purchase high-priced, albeit shady tax advice have vast opportunities to avoid or evade taxes. And sadly, many of them take advantage of those opportunities. These are the Americans who need help in complying with their tax responsibilities.

Far too many corporations, investors and business owners are tempted to understate their gross business receipts and/or overstate their expenses, move their investments or profits offshore, fail to report their capital gains accurately, and so forth. Not all succumb, of course. Even for those who do, the actual means for making income disappear for tax purposes is probably often a mystery. That doesn't absolve the tax cheats and aggressive avoiders from blame: they're the demand side of the equation. But without the supply side, the ethically-challenged lawyers, accountants and banks that set up the shelters, the demand would go unrequited.

The majority of us who honestly pay our taxes have a major stake in getting the tax dodgers to ante up — hundreds of billions of dollars a year, in fact, although no one knows the exact amount for sure. We probably can't collect all of that, but IRS Commissioner Mark Everson indicated last year that $50-100 billion a year in additional revenues could be fairly easily collected from tax cheats if the IRS had the resources and the tools.

Everson's estimate may be too modest, given what he's apparently not counting. Tax experts Joseph Guttentag and Reuvan Avi-Yonah point out that "no one, including the IRS, has a good estimate of the size of the [United States'] *international* tax gap," since keeping these kinds of illegal offshore schemes from being discovered by the IRS is the key to making them work. Guttentag and Avi-Yonah suggest that $50 billion a year is a reasonable guess about the level of U.S. tax evasion in the international area that could be "eliminated overnight" with the right policy changes, and note that IRS consultant Jack Blum thinks upwards of $70 billion a year is more likely.[1]

Proposals for Improved Enforcement

With all this money at stake, what do we need to do to collect some of it?

Well, as much as possible, we need to lift the veil of secrecy about what the tax evaders are doing. We need to clarify or change the tax laws to make tax-evasion schemes indefensible from a legal standpoint. We need to find further ways to deter the tax-evasion advisors and financial firms that facilitate tax cheating. Perhaps most important, we need to give the IRS the resources to enforce the laws.

To be sure, these will not be easy tasks to accomplish. There are well-organized, well-financed lobbying organizations that will fight such reforms — led by the accounting firms, banks and lawyers that now make billions of dollars a year facilitating tax evasion and avoidance. But there are also leaders in Congress who have taken on the Tax Cheaters Lobby. In the Senate, the good guys include Carl Levin and Norm Coleman, who have been instrumental in exposing some of the worst tax-sheltering activities by the big accounting firms; Byron Dorgan, who has fought against corporate offshore sheltering for decades; and

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[1]Joseph Guttentag and Reuben Avi-Yonah, "Closing the international tax gap," *Bridging the Tax Gap*, Economic Policy Institute, 2005, pp. 101 & 107.

Charles Grassley, who as Senate Finance Committee Chairman held some excellent hearings on tax evasion and sponsored excellent legislation to curb egregious cheating.

Here are some specific suggestions (which are not meant to be comprehensive):

A. Crack down on Offshore Income Shifting and Non-Reporting:

Last year's Levin-Coleman hearings highlighted how serious this problem is by showing how three high-profile American tax cheats evaded taxes on billions of dollars in income through offshore tax dodges. This is a worldwide concern, not just one for the United States, as we recently learned from news stories about how the Rolling Stones and U-2's Bono have shifted their song-writing profits out of the United Kingdom to dodge billions of pounds in taxes. So, we and other nations need to cooperate to force comprehensive sharing of information among countries, especially from tax havens. The Tax Cheaters Lobby is especially afraid of this kind of reform, because offshore hiding is at the heart of many tax evasion schemes. Many foreign governments would welcome a cooperative crackdown on international bank secrecy — in fact, the U.S. was leading an effort to achieve that until the Bush administration pulled the plug on such cooperation soon after it took office in 2001.

To address offshore tax cheating, Senators Levin and Coleman have proposed the following (quoted from their 2006 report):

> **1. Presumption of Control.** U.S. tax, securities, and anti-money laundering laws should include a presumption that offshore trusts and shell corporations are under the control of the U.S. persons supplying or directing the use of the offshore assets, where those trusts or shell corporations are located in a jurisdiction designated as a tax haven by the U.S. Treasury Secretary.
>
> **2. Disclosure of U.S. Stock Holdings.** U.S. publicly traded corporations should be required to disclose in their SEC filings company stock held by an offshore trust or shell corporation related to a company director, officer, or large shareholder, even if the offshore entity is allegedly independent. Corporate insiders should be required to make the same disclosure in their SEC filings.
>
> **3. Offshore Entities as Affiliates.** An offshore trust or shell corporation related to a director, officer, or large shareholder of a U.S. publicly traded corporation should be required to be treated as an affiliate of that corporation, even if the offshore entity is allegedly independent.
>
> **4. 1099 Reporting.** Congress and the IRS should make it clear that a U.S. financial institution that opens an account for a foreign trust or shell corporation and determines, as part of its anti-money laundering duties, that the beneficial owner of the account is a U.S. taxpayer, must file a 1099 form with respect to that beneficial owner.
>
> **5. Real Estate and Personal Property.** Loans that are treated as trust distributions under U.S. tax law should be expanded to include, not just cash and securities as under present law, but also loans of real estate and personal property of any kind including artwork, furnishings and jewelry. Receipt of cash or other property from a foreign trust, other than in an exchange for fair market value, should also result in treatment of the U.S. person as a U.S. beneficiary.
>
> **6. Hedge Fund AML Duties.** The Treasury Secretary should finalize a proposed regulation requiring hedge funds to establish anti-money laundering programs and report suspicious transactions to U.S. law enforcement. This regulation should apply to foreign-based hedge funds that are affiliated with U.S. hedge funds and invest in the United States.
>
> **7. Stock Option-Annuity Swaps.** Congress and the IRS should make it clear that taxes on stock option compensation cannot be avoided or deferred by exchanging stock options for other assets of equivalent value such as private annuities.

8. **Sanctions on Uncooperative Tax Havens.** Congress should authorize the Treasury Secretary to identify tax havens that do not cooperate with U.S. tax enforcement efforts and eliminate U.S. tax benefits for income attributed to those jurisdictions.[2]

To the Levin-Coleman reform list in the international area can be added the following:

9. **Not only deny all deductions for transfers to tax havens that refuse to disclose activity by U.S. residents automatically, but also make it illegal for U.S. financial companies to deal with uncooperating tax havens.** Some argue that we would need to get every other non-tax-haven real country on board with this type of proposal, or otherwise people will route their transactions through real countries into the tax havens. But as noted, other countries are likely to be eager to join us in this effort. In fact, the OECD's new model treaty envisions this result.

10. **Repeal so-called "deferral" of taxes on the profits earned by American-owned foreign corporations.** This reform was proposed by President Kennedy back in the early 1960s and by John Kerry in his 2004 presidential campaign. "Deferral," which is really closer to exemption of income that is styled as foreign, is at the heart of offshore tax avoidance. People and companies that actually have overseas activities and pay taxes on them abroad have little to fear from the end of deferral because they get a tax credit for the foreign income taxes they pay. But without deferral, schemes that allow people and companies to artificially shift U.S. profits offshore will largely be stymied. As a bonus, American companies would no longer have a tax incentive to move U.S. jobs to low-tax foreign countries.

11. **Replace our current "transfer pricing" system of allocating corporate profits among jurisdictions with a more easily enforceable formula approach.** Currently, the IRS has the impossible task of trying to police billions of imputed intracompany transactions in order to allocate profits among countries. A simpler formula approach, already used by most American states and long promoted by Sen. Byron Dorgan, holds out the potential for putting serious curbs on what has developed into a major tax evasion/avoidance industry.

12. **Adopt the Joint Committee on Taxation Staff Proposals Regarding Deductions and Credits with Respect to Untimely Returns of Nonresident Aliens and Foreign Corporations.** This proposal would reverse a federal court decision (currently on appeal) that allows foreign corporations doing business in the United States to avoid filing required tax returns. The change would impose potentially severe penalties on such corporations that fail to file.

13. **Adopt the Joint Committee on Taxation Staff Proposals Regarding Offshore Earnings Stripping.** This proposal would increase disclosure and eliminate an unwarranted "safe-harbor" rule that allows corporations to shift U.S. profits offshore. It would also discourage corporate "inversions" into paper foreign corporations.

B. Require Information Reporting on Capital Gains.

Right now, small investors in mutual funds get all their capital gains reported, but better-off investors who work through stockbrokers do not. As a result, untold billions of dollars in capital gains go unreported and untaxed. A recent report to Senator Grassley by the Joint Committee on Taxation staff spelled out how such reporting could work, not only for stock

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[2]Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, Tax Haven Abuses: the Enablers, the Tools, and Secrecy, http://hsgac.senate.gov/_files/taxhavenabuses8106final.pdf, Aug. 1, 2006, p. 10.

capital gains but also for capital gains in auction sales of collectibles and similar items.[3]

C. Consider Enacting a Tough "Economic Substance" Rule.

Since the 1940s, courts have sometimes been willing to disallow tax-shelter schemes if they lack "economic substance." But what exactly "economic substance" means has never been completely clear. Senator Grassley has proposed to clarify and codify the economic substance rule. We support such as effort as long as the rule is defined very strictly: If tax avoidance is the primary purpose of a scheme, then it should be disallowed. In contrast, Senator Grassley's bill requires only a "substantial" non-tax purpose (among other important restrictions).[4]

D. Clarify the Law Governing Self-employment Taxes on Subchapter S Corporation Owners.

Sole proprietors and active partners are generally subject to self-employment taxes on all of their earnings. But many Subchapter S corporation owners are taking advantage of ambiguity in the IRS regulations to claim that most of their earnings are exempt from self-employment tax. The same recent report by the Joint Committee on Taxation staff cited in "B" above spells out how the rules could be changed to close this scandalous loophole.[5]

E. Help Small Businesses Comply Through Expanded 1099 Information Reporting.

According to the GAO, independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. GAO also notes that payments made by businesses to corporations for services are generally not required to be reported on information returns, and that the Taxpayer Advocate Service supports requiring information reporting on payments made to corporations.[6] Expanding such reporting would almost certainly help improve small business compliance.

F. Continue to Increase Penalties on Tax-Evasion Facilitators.

Those who assist tax evasion in the (sadly reasonable) hope that they will not be caught should be penalized very severely when they are apprehended. Further increases in penalties might help deter bad behavior.

G. Tax Simplification.

A simpler tax code, in which the IRS is not put in charge of dozens of non-tax related programs, would free up the IRS to better do its real job: collect taxes fairly and accurately. It would also make it much easier for well-intentioned taxpayers to comply with the law, and make it harder for those not so inclined to evade taxes.

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[3] Joint Committee on Taxation, "Additional Options to Improve Tax Compliance," Aug. 3, 2006.

[4] In general, Sen. Grassley's economic substance reform "provides that a transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such trans-action and the transaction is a reasonable means of accomplishing such purpose." It goes on to further define the meaning of this general rule. Senate Report 108-11, "CARE Act of 2003," S. 476, Feb. 27, 2003, pp. 78-79.

[5] Joint Committee on Taxation, "Additional Options to Improve Tax Compliance," Aug. 3, 2006.

[6] GAO, "Testimony Before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate," July 26, 2006.

H. Sharply Increase IRS Funding.

This may be the most important step of all.

In recent years, the IRS has gotten a lot of publicity for its crackdown on some particularly egregious tax evasion activities, including the Walter Anderson case and the so-called "Son of BOSS" tax dodge — one of the many complicated shelters marketed by major accounting firms. These and other shocking exposes have helped raise public ire against tax cheats, so much so that President Bush even bragged in his fiscal 2006 budget proposal that he was proposing a big increase in IRS enforcement funding.

So have we turned the corner on combating tax evasion by corporations and the wealthy? Hardly. Consider how severely the IRS's ability to curb tax sheltering and evasion — or even to know how much is occurring — has been reduced over the past decade by Congress:

- From 1994 to the present, the overall IRS budget has been slashed by more than a fifth, both as a share of the economy and in terms of the number of IRS employees compared to the total U.S. population.
- In the enforcement area, the cutbacks have been even more severe. The Inspector General for Tax Administration reported that the IRS's "enforcement staff declined from 25,000 at the beginning of FY 1996 to 16,000 at the end of FY 2003, a 36 percent decrease."
- IRS audit rates, of both businesses and individuals, declined precipitously, especially for upper-income tax returns. In 1996, the IRS audited 210,000 returns of people reporting more than $100,000 in income. By 2001, the number had fallen to only 92,000 — even as the number of returns with incomes above $100,000 jumped by 80 percent.
- In the mid-nineties, a misled Congress even prohibited the IRS from doing any research on tax evasion.

Very recently, the IRS has finally been permitted to do some limited research on tax evasion, but that research remains inadequate. Audit rates have begun to climb again, but they're still well below where they were a decade ago. Although a small portion of the IRS's resources has been moved away from taxpayer assistance and into enforcement, the IRS's enforcement staff remains more than a third below what it was a decade ago, despite the explosion in aggressive tax shelters and outright fraud since then. As for the President's supposed increases in the IRS budget, they haven't been enough even to keep up with wage growth.

The results of these cutbacks have been illustrated not just in the IRS's failures to control tax evasion, but even in some of its ostensible successes. For example, last September, the IRS settled a major transfer-pricing/intangible-property case with GlaxoSmithKline, in which the British-based drug company agreed to pay $3.4 billion in back taxes covering the 1989-2005 period.[7] This was trumpeted as the biggest single tax settlement in history. The bad news, however, as the *Washington Post* reported, is that "Glaxo estimated that the matter could have cost it as much as $15 billion."[8] As Senator Byron Dorgan pointed out (in the *Post* story), "One of the messages" from the Glaxo settlement "might be that you can settle for substantially less than you allegedly owe."

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[7] "Glaxo to Settle Tax Dispute With IRS Over U.S. Unit for $3.4 Billion," by Robert Guy Matthews and Jeanne Whalen, *The Wall Street Journal*, September 12, 2006.

[8] "Glaxo To Pay IRS $3.4 Billion, Tax Settlement Is Biggest in Agency's History," by David S. Hilzenrath, *The Washington Post*, Sept. 12, 2006.

Likewise, the *New York Times* reported on January 17, 2007 that a survey of 50 IRS corporate auditors found that every one felt that "large companies were being allowed to pay far less than they owed" in taxes due to insufficient IRS resources to fully pursue cases. "It's catch and release," one auditor told the *Times*, about how little tax-cheating corporations were forced to pay when their illegal activities are detected. "They are giving away the store," another auditor complained.[9]

So all of the substantive changes outlined earlier (and others not mentioned) are important. But none of them will do the trick unless we have enough tax police to use the disclosure and enforce the laws. So the most essential step that needs to be taken is simply to give the IRS more resources.

Just to return to the staffing levels of a decade ago would require a 50 percent increase in the IRS enforcement budget. Given the increase in tax sheltering since then, phasing in a doubling of the resources devoted to tax enforcement would not be an unreasonable goal. Fortunately, we don't have to worry about the cost. On the contrary, increasing the IRS budget is one kind of government spending that actually increases revenues.

With additional funding, the IRS could devote more resources to international tax evasion, partnership document matching, capital gains under-reporting, serious research and an array of other critical enforcement activities. According to IRS estimates, it could collect from $5 to more than $30 for every dollar spent on improved enforcement.[10] If enforcement changes deter people and companies from even attempting abusive tax sheltering activities, then the rate of return could be even higher.

In this light, it might be appropriate to change the congressional budget rules as they apply to the IRS. After all, if IRS were treated like other agencies, its "offsetting receipts" would make its $11 billion budget appear to be a negative $2.2 trillion! Given that, the National Taxpayer Advocate proposes rethinking the IRS's budget treatment in her 2006 annual report to Congress.[11]

Conclusion

The stakes in tax evasion are very high, and the forces in favor of maintaining the status quo are well-financed and very politically connected. But it's our money the tax cheats are stealing. On behalf of honest taxpayers, CTJ calls on federal lawmakers do something about it.

[9] "Agents Say Fast Audits Hurt I.R.S.," by David Cay Johnston, *The New York Times*, Jan. 17, 2007.

[10] According to the National Taxpayer's Advocate, "On a budget of about $10.6 billion, the IRS currently collects about $2.24 trillion a year. That translates to an average return-on-investment (ROI) of about 210:1. . . . [F]ormer Commissioner Rossotti reported the IRS was receiving sufficient resources to work only 40 percent of some 4.5 million accounts receivable cases each year. IRS research estimated that with an additional $296.4 million, the agency could collect $9.47 billion. That translates to a return on investment of 32:1." *National Taxpayer Advocate's 2006 Annual Report to Congress*, Dec. 31, 2006, pp. 442 & 444.

[11] "The National Taxpayer Advocate makes the following recommendations: Congress should consider revising its budget rules in a manner that allows the budget and appropriations committees to make a judgment about the answer to the question: 'What level of funding will maximize tax compliance, particularly voluntarily compliance, with our nation's tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?' and then set the IRS funding level accordingly, without regard to spending caps." *National Taxpayer Advocate's 2006 Annual Report to Congress*, Dec. 31, 2006, p. 445.

Chairman CONRAD. Thank you very much for your testimony.

Mr. Brostek, welcome. I should indicate once again, Mr. Brostek is with the General Accounting Office, who have studied this issue in some detail. We welcome you to the committee.

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX ISSUES, STRATEGIC ISSUES TEAM, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. BROSTEK. Thank you, very much.

Chairman Conrad, Senator Gregg, and members of the committee, I am pleased to participate in the committee's hearing today on approaches to reducing the tax gap.

My statement discusses the need for multiple approaches to successfully reduce the tax gap, including the importance of quality service to taxpayers and then covers potential reductions in the tax gap that could ensue from simplifying or reforming the tax code, providing IRS more tools to deal with noncompliance, and dedicating more resources to enforcement.

Before I address the approaches for reducing the tax gap, perhaps it would be useful to explain a little more about what the tax gap entails. The tax gap, as was mentioned, is the difference between the tax amounts that taxpayers voluntarily and timely pay and what they should pay under the law. The tax gap covers the individual and corporate income taxes, employment taxes, estate taxes and excise taxes. Individual income taxes have the largest estimated gap, about $244 billion out of the total gross gap of $345 billion estimated by IRS for tax year 2001.

For each type of tax there can be three different kinds of noncompliance: under reporting of income, under payment of taxes that are owed, and non-filing of returns. Of these, under reporting of income is by far the largest noncompliance issue with an estimated $285 billion of the total gap attributed to under reporting of income.

Under reporting of income includes not only the direct failure to report income that was earned, but also such things as over claiming deductions and credits that offset income.

In summary, the tax gap is a persistent problem and, as the saying goes, we will keep on getting the same result—an unacceptable gap—if we keep on doing the same things. We need to try new approaches. We need to make greater use of current effective approaches.

While simplification, more tools, and more resources all have the potential to help reduce the tax gap, using multiple approaches is likely to be the best strategy. No one strategy is likely to fully and cost-effectively reduce the tax gap, for example because the gap has multiple causes, spans differing types of taxes, and differing types of taxpayers.

Providing quality service is a necessary foundation to achieving high levels of compliance. IRS taxpayer services includes such things as education and outreach programs, simplifying tax processes, and revising forms and publications to make them electronically accessible and more easily understood by the taxpayers. Quality services can help those who wish to comply but do not understand their obligations, and such services are also needed if other approaches are taken to reduce the tax gap.

For example, even if we simplify the tax laws, as has been suggested, IRS would need to have an outreach program to educate taxpayers about those changes and to answer questions that would undoubtedly come from the taxpayers.

In addition to quality service, a few of the following things are also important to tax gap reduction. We need to periodically measure noncompliance and its causes, set tax gap reduction goals, consider the cost and burdens associated with various efforts to reduce the tax gap, evaluate the results of any initiatives that are undertaken so we know what works, optimize IRS's internal allocation of resources, and leverage technology.

Turning to simplification or tax reform, there is no reliable estimate of the degree to which simplification could reduce the tax gap. Nonetheless, one indication of the potential is that IRS estimated a revenue shortfall of $32 billion occurred in 2001 due to errors that taxpayers made in claiming various tax credits, deductions, et cetera. Over the decades, the tax code has layered on more and more special tax provisions with the number of tax expenditures, as they are called, like credits and deductions doubling in number between 1974 and 2005. By making the rules across differing tax provisions more uniform, by merging multiple related provisions, and by deleting provisions that may not be accomplishing their intended purpose at an acceptable revenue cost, the tax code could be simplified. And if so, both intentional and unintentional errors should decline.

Further, to the extent that tax simplification reduces errors, IRS would be able to relocate its resources to focus on more problematic areas of noncompliance. However, of course, each tax code provision was created for a purpose and simplifying the code is likely to be challenging.

Tax reform also has the potential to reduce the tax gap, but it is most likely to be effective if any reformed system has few, if any, tax preferences and importantly, taxable transactions are transparent to the tax agency. These characteristics are difficult to achieve and, to my knowledge, all tax systems have some sort of tax gap.

Tax withholding and information reporting are among the most powerful tools for promoting compliance. If we can spread these tools across more types of income that are the major contributors to the tax gap, substantial tax gap reductions are likely. Our recent work suggests that requiring information reporting on the basis for security sales like stock transactions has the potential to improve compliance with capital gains reporting. Importantly, a key additional benefit would be less taxpayer burden to understand and comply with the complex basis reporting rules. Additional opportunities for withholding and information reporting exist for payments to independent contractors and for payments made to corporations for services they provide to businesses.

Finally, devoting additional resources to enforcement has the potential to reduce the tax gap by billions of dollars. In part, devoting greater resources to enforcement could reduce the gap because every year IRS identifies far more cases of probable noncompliance than it can possibly address. How much the tax gap could be reduced if IRS resources were increased would depend on a number of things, including importantly information. Which taxpayers are noncompliant? Why are they noncompliant? And what amount of tax noncompliance can be corrected for a given dollar of additional investment in IRS resources?

We and others have frequently called for improved information like this to ensure sound management of IRS's limited resources. In part, this is why we have encouraged IRS to undertake compliance studies like the National Research Program that resulted in this most recent tax gap estimate.

As a caution, if additional resources are devoted to enforcement, returns on that investment are likely to lag as IRS hires and trains new personnel. In the past, hiring initiatives generally have reduced revenues in the initial year because new agents tend to be less productive than experienced agents, and IRS uses experienced agents to train the new agents which reduces the experienced agents' productivity.

Also, several years tend to lapse between the assessment of taxes and the collection of those taxes. For instance, in a 1998 study we found that 5 years after taxes were assessed against individual taxpayers for business income, 48 percent of those taxes had been collected.

This concludes my oral statement. I would be happy to answer any questions.

[The prepared statement of Mr. Brostek follows:]

United States Government Accountability Office

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TAX COMPLIANCE

Multiple Approaches Are Needed to Reduce the Tax Gap

Statement of Michael Brostek
Director, Tax Issues
Strategic Issues Team

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Highlights

Highlights of GAO-07-391T, a testimony to the Committee on the Budget, U.S. Senate

TAX COMPLIANCE

Multiple Approaches Are Needed to Reduce the Tax Gap

Why GAO Did This Study

The tax gap—the difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law—has been a long-standing problem in spite of many efforts to reduce it. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap for tax year 2001 of $345 billion and estimated it would recover $55 billion of this gap, resulting in a net tax gap of $290 billion. When some taxpayers fail to comply, the burden of funding the nation's commitments falls more heavily on compliant taxpayers. Reducing the tax gap would help improve the nation's fiscal stability. For example, each 1 percent reduction in the net tax gap would likely yield $3 billion annually.

GAO was asked to discuss the tax gap and various approaches to reduce it. This testimony discusses the need for taking multiple approaches and to what extent the tax gap could be reduced through three overall approaches—simplifying or reforming the tax system, providing IRS with additional enforcement tools, and devoting additional resources to enforcement. This statement is based on prior GAO work.

What GAO Recommends

GAO is not making any new recommendations but highlights areas for possible attention.

www.gao.gov/cgi-bin/getrpt?GAO-07-391T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov

What GAO Found

Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since, for example, it has multiple causes and spans different types of taxes and taxpayers. Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major approaches, but providing quality services to taxpayers also is a necessary foundation for voluntary compliance. Such steps as periodically measuring noncompliance and its causes, setting tax gap reduction goals, evaluating the results of any initiatives to reduce the tax gap, optimizing the allocation of IRS's resources, and leveraging technology to enhance IRS's efficiency would also contribute to tax gap reduction.

Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by billions of dollars. IRS has estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Thus, considerable potential exists. However, these provisions serve purposes Congress has judged to be important and eliminating or consolidating them could be complicated. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to achieve, and any tax system could be subject to noncompliance.

Withholding and information reporting are particularly powerful tools to reduce the tax gap. They could help reduce the tax gap by billions of dollars, especially if they make underreported income transparent to IRS. These tools have led to high, sustained levels of taxpayer compliance and improved IRS resource allocation by helping IRS identify and prioritize its contacts with noncompliant taxpayers. As GAO previously suggested, reporting the cost, or basis, of securities sales is one option to improve taxpayers' compliance. However, designing additional withholding and information reporting requirements may be challenging given that many types of income are already subject to reporting, underreporting exists in many forms, and withholding and reporting requirements impose costs on third parties.

Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of IRS enforcement resources requires taking into account such factors as how well IRS uses its resources, the proper balance between taxpayer service and enforcement activities, and competing federal funding priorities. If Congress provides IRS more enforcement resources, the amount of tax gap reduction would depend on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Increasing IRS's funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but does not contact.

Chairman Conrad, Senator Gregg, Members of the Committee:

I appreciate this opportunity to discuss the tax gap—the difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law—and what is achievable in reducing the gap. Most recently, the Internal Revenue Service (IRS) estimated that for tax year 2001, taxpayers paid about 84 percent of the taxes that should have been paid on time under the law, resulting in an estimated gross tax gap of $345 billion. IRS estimated that it would eventually recover around $55 billion of the 2001 tax gap through late payments and IRS enforcement actions, leaving a net tax gap of $290 billion.[1] Because of taxpayer noncompliance, the burden of funding the nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes. Reducing the tax gap would help improve the nation's fiscal stability. For example, based on IRS's estimate, each 1 percent reduction in the net tax gap would likely yield nearly $3 billion annually. However, the tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. Likewise, factors such as globalization and the ever-increasing complexity of the tax code challenge IRS's ability to administer the tax code.

My remarks focus on what is achievable in reducing the tax gap through a variety of approaches. First I will discuss the need for multiple approaches towards reducing the tax gap. Then I will discuss three specific tax gap reduction approaches: (1) simplifying or reforming the tax system; (2) providing IRS additional enforcement authority and tools, such as information reporting[2] and tax withholding,[3] through changes to the tax laws; and (3) devoting additional resources to enforcement under the existing tax laws. My remarks are based on our previous work on a variety of issues, in particular, recent testimonies and a report on reducing the tax

[1]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

[2]Information reporting involves the filing of information returns with IRS and taxpayers that contain information on certain transactions, such as wage and salary information employers report to employees and IRS through Form W-2.

[3]An example of tax withholding is when employers withhold taxes on the wages that employees earn and remit them to IRS.

gap.[4] These efforts were conducted in accordance with generally accepted government auditing standards.

Let me begin by highlighting four major points:

- Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since, for example, it has multiple causes and spans different types of taxes and taxpayers. Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major approaches discussed below, but providing quality services to taxpayers also is a necessary foundation for voluntary compliance. Quality services can help taxpayers who wish to comply but do not understand their obligations, whereas enforcement actions may be needed for those who intentionally evade their tax obligations. Such steps as periodically measuring noncompliance and its causes, setting tax gap reduction goals, considering the costs and benefits of initiatives to reduce the gap, evaluating the results of such initiatives undertaken, optimizing the allocation of IRS's resources, and leveraging technology to enhance IRS's efficiency would also contribute to tax gap reduction.
- Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by many billions of dollars. For example, IRS estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Reducing the number of such credits and deductions therefore has some direct potential to reduce the tax gap. However, these credits and deductions serve purposes Congress has judged to be important, and eliminating them likely would be complicated. Fundamental tax reform, such as shifting to a consumption tax system, would most likely result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few or no tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to

[4]GAO, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (Washington, D.C.: July 26, 2006); *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, GAO-06-453T (Washington, D.C.: Feb. 15, 2006); *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance*, GAO-06-208T (Washington, D.C.: Oct. 26, 2005); *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005); and *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005).

achieve in any system, and any tax system could be subject to noncompliance.

- Providing IRS with more enforcement tools, particularly withholding and information reporting, also has the potential to reduce the tax gap by billions of dollars, especially if those tools help IRS deal with the largest contributor to the tax gap—underreported income. Tax withholding and information reporting have been shown to lead to high, sustained levels of taxpayer compliance because the income taxpayers earn is transparent to them and IRS. Also, using these tools can help IRS better allocate its resources by improving its ability to identify and prioritize noncompliant taxpayers to be contacted. For example, we found that having third parties report to taxpayers and IRS the cost, or basis, of stocks and mutual funds that taxpayers sell could help taxpayers improve their voluntary compliance and help IRS allocate its enforcement efforts concerning these transactions. However, designing withholding or information reporting requirements to address underreporting may be challenging given that many types of income are already subject to such requirements, underreporting exists in many forms, and any requirements could impose costs and burdens on the third parties that withhold or report.

- Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount the tax gap could be reduced depends in part on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Providing IRS with additional funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but currently cannot contact given resource constraints.

Background

The tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been paid voluntarily and on time and what was actually paid for a specific year. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.[5] IRS's tax gap estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers. As shown in table 1, underreporting of tax liabilities accounted for most of the tax gap estimate for tax year 2001.

Table 1: IRS's Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax

Dollars in billions

	Type of tax					
Type of noncompliance	**Individual income tax**	**Corporate income tax**	**Employment tax**	**Estate tax**	**Excise tax**	**Total**
Underreporting	$197	$30	$54	$4	No estimate	**$285**
Underpayment	23	2	5	2	$1	**$34**
Nonfiling	25	No estimate	No estimate	2	No estimate	**$27**
Total	**$244**	**$32**	**$59**	**$8**	**$1**	**$345**

Source: IRS.

Note: Figures may not sum to totals because of rounding.

IRS has estimated the tax gap on multiple occasions, beginning in 1979, relying on its Taxpayer Compliance Measurement Program (TCMP). IRS did not implement any TCMP studies after 1988 because of concerns about costs and burdens on taxpayers. Recognizing the need for current compliance data, in 2002 IRS implemented a new compliance study called the National Research Program (NRP) to produce such data for tax year 2001 while minimizing taxpayer burden.

IRS has concerns with the certainty of the tax gap estimate for tax year 2001 in part because some areas of the estimate rely on old data, IRS has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance. IRS used data from NRP to estimate individual income tax underreporting and the portion of employment tax underreporting attributed to self-employed individuals. The underpayment segment of the tax gap is not an estimate, but rather represents the tax amounts that taxpayers reported on time but did not pay on time. Other areas of the estimate, such as corporate income tax and employer-withheld employment tax underreporting, rely on decades-old data. Also, IRS has no estimates for corporate income, employment, and

[5]Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed on time.

excise tax nonfiling or for excise tax underreporting.[6] In addition, it is inherently difficult for IRS to observe and measure some types of underreporting or nonfiling, such as tracking cash payments that businesses make to their employees, as businesses and employees may not report these payments to IRS in order to avoid paying employment and income taxes, respectively.[7]

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. IRS seeks to improve voluntary compliance through efforts such as education and outreach programs and tax form simplification. IRS uses its enforcement authority to ensure that taxpayers are reporting and paying the proper amounts of taxes through efforts such as examining tax returns and matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns it receives from third parties. IRS reports that it collected over $48 billion in fiscal year 2006 from noncompliant taxpayers it identified through its various enforcement programs.

In spite of IRS's efforts to improve taxpayer compliance, the rate at which taxpayers pay their taxes voluntarily and on time has tended to range from around 81 percent to around 84 percent over the past three decades. Any significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance.[8]

Multiple Approaches Are Needed to Reduce the Tax Gap

No single approach is likely to fully and cost-effectively address noncompliance and therefore multiple approaches are likely to be needed. The tax gap has multiple causes; spans five types of taxes; and is spread over several types of taxpayers including individuals, corporations, and partnerships. Thus, for example, while simplifying laws should help when noncompliance is due to taxpayers' confusion, enforcement may be

[6] For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable.

[7] For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

[8] In some instances, the amount of the tax gap can change without a corresponding change in the level of compliance. For example, a reduction in marginal tax rates could result in a smaller tax gap even if the level of compliance remains unchanged because the amount of taxes that should be paid has been reduced. The tax gap would also tend to increase over time, even if the rate of taxpayer compliance remained unchanged, because of inflation.

needed for taxpayers who understand their obligations but decline to fulfill them. Similarly, while devoting more resources to enforcement should increase taxes assessed and collected, too great an enforcement presence likely would not be tolerated.

Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major tax gap reduction approaches discussed in more detail below, but providing quality services to taxpayers plays an important role in improving compliance and reducing the tax gap. IRS taxpayer services include education and outreach programs, simplifying the tax process, and revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. For example, if tax forms and instructions are unclear, taxpayers may be confused and make unintentional errors. Quality taxpayer services would also be a key consideration in implementing any of the approaches for tax gap reduction. For example, expanding enforcement efforts would increase interactions with taxpayers, requiring processes to efficiently communicate with taxpayers. Also, changing tax laws and regulations would require educating taxpayers of the new requirements in a clear, timely, and accessible manner. In 2006, we reported that IRS improved its two most commonly used services—telephone and Web site assistance—for the 2006 filing season.[9] Increased funding financed some of the improvements, but a significant portion has been financed internally by efficiencies gained from increased electronic filing of tax returns and other operational improvements.

Although quality service helps taxpayers comply, showing a direct relationship between quality service and compliance levels is very challenging. As required by Congress, IRS is in the midst of a study that is to result in a 5-year plan for taxpayer service activities, which is to include long-term quantitative goals and to balance service and enforcement. Part of the study focuses on the effect of taxpayer service on compliance. A Phase I report was issued in April 2006 and a Phase II report is due in early 2007, which is to include, among other things, a multiyear plan for taxpayer service activities and improvement initiatives.

[9] GAO, *Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request*, GAO-06-499T (Washington, D.C.: Apr. 27, 2006).

However, in deciding on the appropriate mix of approaches to use in reducing the tax gap, many factors or issues could affect strategic decisions. Among the broad factors to consider are the likely effectiveness of any approach, fairness, enforceability, and sustainability. Beyond these, our work points to the importance of the following:

- **Measuring compliance levels periodically and setting long-term goals.** A data-based plan is one key to closing the tax gap. To the extent that IRS can develop better compliance data, it can develop more effective approaches for reducing the gap. Regularly measuring the magnitude of, and the reasons for, noncompliance provides insights on how to reduce the gap through potential changes to tax laws and IRS programs. In July 2005, we recommended that IRS periodically measure tax compliance, identify reasons for noncompliance, and establish voluntary compliance goals.[10] IRS agreed with the recommendations and established a voluntary tax compliance goal of 85 percent by 2009. Furthermore, we have identified alternative ways to measure compliance, including conducting examinations of small samples of tax returns over multiple years, instead of conducting examinations for a larger sample of returns for one tax year, to allow IRS to track compliance trends annually.

- **Considering the costs and burdens.** Any action to reduce the tax gap will create costs and burdens for IRS; taxpayers; and third parties, such as those who file information returns. For example, withholding and information reporting requirements impose some costs and burdens on those who track and report information. These costs and burdens need to be reasonable in relation to the improvements expected to arise from new compliance strategies.

- **Evaluating the results.** Evaluating the actions taken by IRS to reduce the tax gap would help maximize IRS's effectiveness. Evaluations can be challenging because it is difficult to isolate the effects of IRS's actions from other influences on taxpayers' compliance. Our work has discussed how to address these challenges, for example by using research to link actions with the outputs and desired effects.

- **Optimizing resource allocation.** Developing reliable measures of the return on investment for strategies to reduce the tax gap would help inform IRS resource allocation decisions. IRS has rough measures of return on investment based on the additional taxes it assesses. Developing

[10] GAO-05-753.

such measures is difficult because of incomplete data on the costs of enforcement and collected revenues. Beyond direct revenues, IRS's enforcement actions have indirect revenue effects, which are difficult to measure. However, indirect effects could far exceed direct revenue effects and would be important to consider in connection with continued development of return on investment measures. In general though, the impacts of tax gap reduction by improving voluntary tax compliance can be quite large. For example, if the estimated 83.7 percent voluntary compliance rate that produced a gross tax gap of $345 billion in tax year 2001 had been 85 percent, this tax gap would have been about $287 billion less; if it had been 90 percent, the gap would have been about $132 133 billion less.

- **Leveraging technology.** Better use of technology could help IRS be more efficient in reducing the tax gap. IRS is modernizing its technology, which has paid off in terms of telephone service, resource allocation, electronic filing, and data analysis capability. However, this ongoing modernization will need strong management and prudent investments to maximize potential efficiencies.

Congress has been encouraging IRS to develop an overall tax gap reduction plan or strategy that could include a mix of approaches like simplifying code provisions, increased enforcement, and reconsidering the level of resources devoted to enforcement. Some progress has been made towards laying out the broad elements of a plan or strategy for reducing the tax gap. On September 26, 2006, the U.S. Department of the Treasury (Treasury), Office of Tax Policy released "A Comprehensive Strategy for Reducing the Tax Gap." However, the document generally does not identify specific approaches that Treasury and IRS will undertake to reduce the tax gap, the related time frames for such steps, or explanations of how much the tax gap would be reduced. The document said that such additional details the would be part of the fiscal year 2008 IRS budget request that will be deliberated during early 2007 because of the resource implications associated with tax gap reduction.

Reducing the Tax Gap through Tax Simplification or Tax System Reform Depends on Their Design and May Have Effects Beyond Tax Compliance

Tax law simplification and reform both have the potential to reduce the tax gap by billions of dollars. The extent to which the tax gap would be reduced depends on which parts of the tax system would be simplified and in what manner as well as how any reform of the tax system is designed and implemented. Neither approach, however, will eliminate the gap. Further, changes in the tax laws and system to improve tax compliance could have unintended effects on other tax system objectives, such as those involving economic behavior or equity.

Simplification has the potential to reduce the tax gap for at least three broad reasons. First, it could help taxpayers to comply voluntarily with more certainty, reducing inadvertent errors by those who want to comply but are confused because of complexity. Second, it may limit opportunities for tax evasion, reducing intentional noncompliance by taxpayers who can misuse the complex code provisions to hide their noncompliance or to achieve ends through tax shelters. Third, tax code complexity may erode taxpayers' willingness to comply voluntarily if they cannot understand its provisions or they see others taking advantage of complexity to intentionally underreport their taxes.

Simplification could take multiple forms. One form would be to retain existing laws but make them simpler. For example, in our July 2005 report[11] on postsecondary tax preferences, we noted that the definition of a qualifying postsecondary education expense differed somewhat among some tax code provisions, for instance with some including the cost to purchase books and others not. Making definitions consistent across code provisions may reduce taxpayer errors. Although we cannot say the errors were due to these differences in definitions, in a limited study of paid preparer services to taxpayers, we found some preparers claiming unallowable expenses for books.[12] Further, the Joint Committee on Taxation suggested that such dissimilar definitions may increase the likelihood of taxpayer errors and increase taxpayer frustration.[13]

[11]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[12]GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006).

[13]U.S. Congress, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System*, vol. II, 125-6 (April 2001).

Another tax code provision in which complexity may have contributed to the individual tax gap involves the earned income tax credit, for which IRS estimated a tax loss of up to about $10 billion for tax year 1999.[14] Although some of this noncompliance may be intentional, we[15] and the National Taxpayer Advocate[16] have previously reported that confusion over the complex rules governing eligibility for claiming the credit could cause taxpayers to fail to comply inadvertently.

Although retaining but simplifying tax code provisions may help reduce the tax gap, doing so may not be easy, may conflict with other policy decisions, and may have unintended consequences. The simplification of the definition of a qualifying child across various code sections is an example. We suggested in the early 1990s that standardizing the definition of a qualifying child could reduce taxpayer errors and reduce their burden.[17] A change was not made until 2004.[18] However, some have suggested that the change has created some unintended consequences, such as increasing some taxpayers' ability to reduce their taxes in ways Congress may not have intended.[19]

Another form of simplification could be to broaden the tax base while reducing tax rates, which could minimize incentives for not complying. This base- broadening could include a review of whether existing tax expenditures are achieving intended results at a reasonable cost in lost revenue and added burden and eliminating or consolidating those that are not. Among the many causes of tax code complexity is the growing number of preferential provisions in the code, defined in statute[20] as tax

[14]IRS measured the extent of noncompliance with the earned income tax credit in a study separate from NRP.

[15]GAO-06-208T.

[16]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004).

[17]See GAO, *Tax Administration: Erroneous Dependent and Filing Status Claims,* GAO/GGD-93-60, (Washington, D.C: Mar.19, 1993).

[18]Pub. L. No. 108-311 (2004).

[19]See Nina E. Olson, "Uniform Qualifying Child Definition: Uniformity for Most Taxpayers," *Tax Notes,* (April 10, 2006), 225-228; and John Buckley, "Uniform Definition of a Child: Large Unintended Consequences," *Tax Notes,* (March 20, 2006), 1345-1349.

[20]The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 299 (July 12, 1974) (codified at 2 U.S.C. § 622(3)).

expenditures, such as tax exemptions, exclusions, deductions, credits, and deferrals.[21] The number of these tax expenditures has more than doubled from 1974 through 2005. Tax expenditures can contribute to the tax gap if taxpayers claim them improperly. For example, IRS's recent tax gap estimate includes a $32 billion loss in individual income taxes for tax year 2001 because of noncompliance with these provisions. Simplifying these provisions of the tax code would not likely yield $32 billion in revenue because even simplified provisions likely would have some associated noncompliance. Nevertheless, the estimate suggests that simplification could have important tax gap consequences, particularly if simplification also accounted for any noncompliance that arises because of complexity on the income side of the tax gap for individuals.[22]

Despite the potential benefits that simplification may yield, these credits and deductions serve purposes that Congress has judged to be important to advance federal goals. Eliminating them or consolidating them likely would be complicated, and would likely create winners and losers. Elimination also could conflict with other objectives such as encouraging certain economic activity or improving equity.

Similar trade-offs exist with possible fundamental tax reforms that would move away from an income tax system to some other system, such as a consumption tax, national sales tax, or value added tax. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent. However, these characteristics are difficult to achieve in any system and experience suggests that simply adopting a fundamentally different tax system may not by itself eliminate any tax gap.[23] Any tax system could be subject to noncompliance, and its design and operation, including the types of tools made available to tax administrators, will affect the size of any corresponding tax gap. Further, the motivating forces behind tax reform likely include factors beyond tax

[21]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined,* GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

[22]The tax gap for underreported individual income taxes exceeded $150 billion for tax year 2001. However, IRS does not have data on how much of this noncompliance arose because of complexity.

[23]For example, in a 2004 report, the National Audit Office in the United Kingdom reported on the 15.7 percent gap for the value added tax, which was introduced three decades earlier.

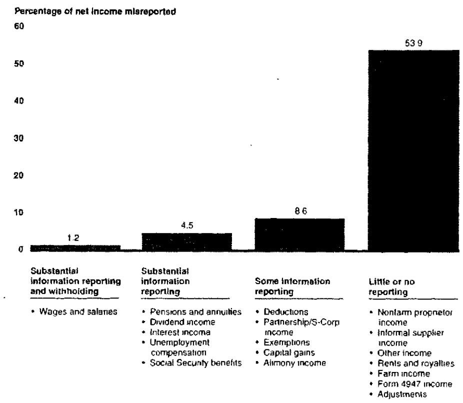
compliance, such as economic effectiveness, equity, and burden, which could in some cases carry greater weight in designing an alternative tax system than ensuring the highest levels of compliance.

Providing IRS with Additional Enforcement Tools Potentially Could Improve Compliance Significantly, but Identifying and Designing Such Tools Can Be Challenging

Changing the tax laws to provide IRS with additional enforcement tools, such as expanded tax withholding and information reporting, could also reduce the tax gap by many billions of dollars, particularly with regard to underreporting—the largest segment of the tax gap. Tax withholding promotes compliance because employers or other parties subtract taxes owed from a taxpayer's income and remit them to IRS. Information reporting tends to lead to high levels of compliance because income taxpayers earn is transparent to them and IRS. In both cases, high levels of compliance tend to be maintained over time. Also, withholding and information reporting help IRS to better identify noncompliant taxpayers and prioritize contacting them, which enables IRS to better allocate its resources. However, designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, underreporting exists in varied forms, and the requirements could impose costs and burdens on third parties.

Taxpayers tend to report income subject to tax withholding or information reporting with high levels of compliance, as shown in figure 1, because the income is transparent to the taxpayers as well as to IRS. Additionally, once withholding or information reporting requirements are in place for particular types of income, compliance tends to remain high over time. For example, for wages and salaries, which are subject to tax withholding and substantial information reporting, the percentage of income that taxpayers misreport has consistently been measured at around 1 percent over time.

Figure 1: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting, Tax Year 2001



Source: IRS.

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:

- **Require more data on information returns dealing with capital gains income from securities sales.** Recently, we reported that an estimated 36 percent of taxpayers misreported their capital gains or losses from the sale of securities, such as corporate stocks and mutual funds.[24] Further, around half of the taxpayers who misreported did so because

[24]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

they failed to report the securities' cost, or basis, sometimes because they did not know the securities' basis or failed to take certain events into account that required them to adjust the basis of their securities. When taxpayers sell securities like stock and mutual funds through brokers, the brokers are required to report information on the sale, including the amount of gross proceeds the taxpayer received; however, brokers are not required to report basis information for the sale of these securities. We found that requiring brokers to report basis information for securities sales could improve taxpayers' compliance in reporting their securities gains and losses and help IRS identify noncompliant taxpayers. However, we were unable to estimate the extent to which a basis reporting requirement would reduce the capital gains tax gap because of limitations with the compliance data on capital gains and because neither IRS nor we know the portion of the capital gains tax gap attributed to securities sales.

- **Requiring tax withholding and more or better information return reporting on payments made to independent contractors.** Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. We have also identified other options for improving information reporting for independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to report separately on their tax returns the total amount of payments to independent contractors.[25]

- **Requiring information return reporting on payments made to corporations.** Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997,[26] payments made by others to corporations are generally not covered by information returns. Information reporting helps IRS to better allocate its resources to the extent that it helps IRS better identify noncompliant taxpayers and the potential for additional revenue that could be obtained by contacting these taxpayers. For example, IRS officials told us that receiving information on

[25]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance,* GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

[26]Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

basis for taxpayers' securities sales would allow IRS to determine more precisely taxpayers' income for securities sales through its document matching programs and would allow it to identify which taxpayers who misreported securities income have the greatest potential for additional tax assessments. Similarly, IRS could use basis information to improve both aspects of its examination program—examinations of tax returns through correspondence and examinations of tax returns face to face with the taxpayer. Currently, capital gains issues are too complex and time consuming for IRS to examine through correspondence. However, IRS officials told us that receiving cost basis information might enable IRS to examine noncompliant taxpayers through correspondence because it could productively select tax returns to examine. Also, having cost basis information could help IRS identify the best cases to examine face to face, making the examinations more productive while simultaneously reducing the burden imposed on compliant taxpayers who otherwise would be selected for examination.

Although withholding and information reporting lead to high levels of compliance, designing new requirements to address underreporting could be challenging given that many types of income, including wages and salaries, dividend and interest income, and income from pensions and Social Security are already subject to withholding or substantial information reporting. Also, challenges arise in establishing new withholding or information reporting requirements for certain other types of income that are extensively underreported. Such underreporting may be difficult to determine because of complex tax laws or transactions or the lack of a practical and reliable third-party source to provide information on the taxable income.

For example, while withholding or information reporting mechanisms on nonfarm sole proprietor and informal supplier income[27] would likely improve their compliance, comprehensive mechanisms that are practical and effective are difficult to identify. As shown in figure 1, this income is not subject to information reporting, and these taxpayers misreported

[27]Nonfarm proprietors are self-employed individuals other than farmers who should file Schedule C with their individual tax returns to report profits and losses from their businesses. Sole proprietors include those who provide services, such as doctors or accountants; produce goods, such as manufacturers; and sell goods at fixed locations, such as car dealers and grocers. Informal suppliers are sole proprietors who work alone or with few workers and, by definition, operate in an informal manner. Informal suppliers include those who make home repairs, provide child care, or sell goods at roadside stands. These taxpayers should report business profits or losses on Schedule C.

about half of the income they earned for tax year 2001. Informal suppliers by definition receive income in an informal manner through services they provide to a variety of individual citizens or small businesses. Whereas businesses may have the capacity to perform withholding and information reporting functions for their employees, it may be challenging to extend withholding or information reporting responsibilities to the individual citizens that receive services, who may not have the resources or knowledge to comply with such requirements.

Finally, implementing tax withholding and information reporting requirements generally imposes costs and burdens on the businesses that must implement them, and, in some cases, on taxpayers. For example, expanding information reporting on securities sales to include basis information will impose costs on the brokers who would track and report the information. Further, trying to close the entire tax gap with these enforcement tools could entail more intrusive recordkeeping or reporting than the public is willing to accept.

Devoting Additional Resources to Enforcement Likely Could Reduce the Tax Gap, but to What Extent Is Difficult to Predict

Devoting more resources to enforcement has the potential to help reduce the tax gap by billions of dollars, as IRS would be able to expand its enforcement efforts to reach a greater number of potentially noncompliant taxpayers. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account many factors, such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount of the tax gap that could be reduced depends in part on the size of any increase in IRS's budget, how IRS would manage any additional resources, and the indirect increase in taxpayers' voluntary compliance that would likely result from expanded IRS enforcement.

Given resource constraints, IRS is unable to contact millions of additional taxpayers for whom it has evidence of potential noncompliance. With additional resources, IRS would be able to assess and collect additional taxes and further reduce the tax gap. In 2002, IRS estimated that a $2.2 billion funding increase would allow it to take enforcement actions against potentially noncompliant taxpayers it identifies but cannot contact and would yield an estimated $30 billion in revenue.[28] For example, IRS estimated that it contacted about 3 million of the over 13 million taxpayers it identified as potentially noncompliant through its matching of tax returns to information returns. IRS estimated that contacting the additional 10 million potentially noncompliant taxpayers it identified, at a cost of about $230 million, could yield nearly $7 billion in potentially collectible revenue. We did not evaluate the accuracy of the estimate, and as will be discussed below, many factors suggest that it is difficult to estimate reliably net revenue increases that might come from additional enforcement efforts.[29]

Although additional enforcement funding has the potential to reduce the tax gap, the extent to which it would help depends on several factors. First, and perhaps most obviously, the amount of tax gap reduction would depend in part on the size of any budget increase. Generally, larger budget increases should result in larger reductions in the tax gap. The degree to which revenues would increase from expanded enforcement depends on many variables, such as how quickly IRS can ramp up efforts, how well IRS selects the best cases to be worked, and how taxpayers react to enforcement efforts. Estimating those revenue increases would require assumptions about these and other variables. Because actual experience is likely to diverge from those assumptions, the actual revenue increases are likely to differ from the estimates. The lack of reliable key data compounds the difficulty of estimating the likely revenues. To the extent possible, obtaining better data on key variables would provide a better understanding of the likely results with any increased enforcement resources.

With additional resources for enforcement, IRS would be able to assess and collect additional taxes, but the related tax gap reductions may not be immediate. If IRS uses the resources to hire more enforcement staff, the reductions may occur gradually as IRS is able to hire and train the staff. Also, several years can elapse after IRS assesses taxes before it actually collects these taxes.

[28] Commissioner of Internal Revenue Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of IRS and the Tax System*, October 2002.

[29] The overall tax gap has many components. Thus, if the tax gap in a specific area is reduced either through congressional actions like simplifying provisions or through IRS actions, the size of the overall gap may not be reduced if other portions of the gap increase.

Similarly, the amounts of taxes actually collected can vary substantially from the related tax amounts assessed through enforcement actions by the type of tax or taxpayer involved. In a 1998 report, we found that 5 years after taxes were assessed against individual taxpayers with business income, 48 percent of the assessed taxes had been collected, whereas for the largest corporate taxpayers, 97 percent of assessed taxes had been collected.[30]

Over the last 2 years, IRS has requested and received additional funding targeted for enforcement activities that it estimated will result in additional revenue. In its fiscal year 2007 budget request, IRS requested an approximate 2 percent increase in funding from fiscal year 2006 to expand its enforcement efforts, including tax return examination and tax collection activities, with the goal of increasing individual taxpayer compliance and addressing concerns that we and others have raised[31] regarding the erosion of IRS's enforcement presence. In estimating the revenue that it would obtain from the increased funding, IRS accounted for several factors, including opportunity costs because of training, which draws experienced enforcement personnel away from the field; differences in average enforcement revenue obtained per full-time employee by enforcement activity; and differences in the types and complexity of cases worked by new hires and experienced hires. IRS forecasted that in the first year after expanding enforcement activities, the additional revenue to be collected is less than half the amount to be collected in later years. This example underscores the logic that if IRS is to receive a relatively large funding increase, it likely would be better to provide it in small but steady amounts.

The amount of tax gap reduction likely to be achieved from any budget increase also depends on how well IRS can use information about noncompliance to manage the additional resources. Because IRS does not have compliance data for some segments of the tax gap and others are based on old data, IRS cannot easily track the extent to which compliance

[30]GAO, *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (Washington, D.C.: June 23, 1998).

[31]GAO issued a number of products regarding the erosion of IRS's enforcement presence and a continued growth in noncompliance. For examples, see GAO, *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2003); *High Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005); and our tax gap products cited earlier in this statement, GAO-06-1000T, GAO-06-453T, GAO-06-208T, GAO-05-753, and GAO-05-527T.

is improving or declining. IRS also has concerns with its information on whether taxpayers unintentionally or intentionally fail to comply with the tax laws. Knowing the reasons for taxpayer noncompliance can help IRS decide whether its efforts to address specific areas of noncompliance should focus on nonenforcement activities, such as improved forms or publications, or enforcement activities to pursue intentional noncompliance. To the extent that compliance data are outdated and IRS does not know the reason for taxpayer noncompliance, IRS may be less able to target resources efficiently to achieve the greatest tax gap reduction at the least taxpayer burden.

IRS has taken important steps to better ensure efficient allocation and use. For example, the NRP study has provided better data on which taxpayers are most likely to be noncompliant. IRS is using the data to improve its audit selection processes in hopes of reducing the number of audits that result in no change, which should reduce unnecessary burden on compliant taxpayers and increase enforcement staff productivity (as measured by direct enforcement revenue).

As part of an effort to make the best use of its enforcement resources, IRS has developed rough measures of return on investment in terms of tax revenue that it assesses from uncovering noncompliance. Generally, IRS cites an average return on investment for enforcement of 4:1, that is, IRS estimates that it collects $4 in revenue for every $1 of funding. Where IRS has developed return on investment estimates for specific programs, it finds substantial variation depending on the type of enforcement action. For instance, the ratio of estimated tax revenue gains to additional spending for pursuing known individual tax debts through phone calls is 13:1, versus a ratio of 32:1 for matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns. In addition to returns on investment estimates being rough, IRS lacks information on the incremental returns on investment from pursuing the "next best case" for some enforcement programs. It is the marginal revenue gain from these cases that matters in estimating the direct revenue from expanded enforcement. Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts. Because IRS's current estimates of the revenue effects of additional funding are imprecise, the actual revenue that might be gained from expanding different enforcement efforts is subject to uncertainty.

Given the variation in estimated returns on investment for different types of IRS compliance efforts, the amount of tax gap reduction that may be achieved from an increase in IRS's resources would depend on how IRS allocates the increase. Although it might be tempting to allocate resources heavily toward areas with the highest estimated return, allocation decisions must take into account diverse and difficult issues. For instance, although one enforcement activity may have a high estimated return, that return may drop off quickly as IRS works its way through potential noncompliance cases. In addition, IRS dedicates examination resources across all types of taxpayers so that all taxpayers receive some signal that noncompliance is being addressed. Further, issues of fairness can arise if IRS focuses its efforts only on particular groups of taxpayers.

Beyond direct tax revenue collection, expanded enforcement efforts could reduce the tax gap even more, as widespread agreement exists that IRS enforcement programs have an indirect effect through increases in voluntary tax compliance.[32] The precise magnitude of the indirect effects of enforcement is not known with a high level of confidence given challenges in measuring compliance; developing reasonable assumptions about taxpayer behavior; and accounting for factors outside of IRS's actions that can affect taxpayer compliance, such as changes in tax law. However, several research studies have offered insights to help better understand the indirect effects of IRS enforcement on voluntary tax compliance and show that they could exceed the direct effect of revenue obtained.[33]

Concluding Observations

When taxpayers do not pay all of their taxes, honest taxpayers carry a greater burden to fund government programs and the nation is less able to address its long-term fiscal challenges. Thus, reducing the tax gap is

[32]Two types of indirect effect are (1) the increase in voluntary compliance in the larger population resulting from examinations or other enforcement and nonenforcement actions on targeted taxpayers, and (2) the increase in voluntary compliance of the targeted taxpayer in subsequent years.

[33]Economists have estimated the indirect effect of an examination on voluntary compliance to range from 6 to 12 times the amount of proposed tax adjustments. See Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96) (Washington, D.C.: November 1996), 2, 35-36; Jeffrey A. Dubin, Michael J. Graetz, and Louis L. Wilde, "The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986," *43 National Tax Journal*, (1990), 395, 396, 405; and Jeffrey A. Dubin, "Criminal Investigation Enforcement Activities and Taxpayer Noncompliance" (paper written for the IRS Research Conference, June 2004), http://www.irs.gov/pub/irs-soi/04dubin.pdf (downloaded July 1, 2005).

important, even though closing the entire tax gap is neither feasible nor desirable because of costs and intrusiveness. All of the approaches I have discussed have the potential to reduce the tax gap alone or in combination, and no single approach is clearly and always superior to the others. As a result, IRS needs a strategy to attack the tax gap on multiple fronts with multiple approaches.

Mr. Chairman and Members of the Committee, this concludes my testimony. I would be happy to answer any question you may have at this time.

Contact and Acknowledgments

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Chairman CONRAD. Thank you, very much.

Next we will turn to Mr. Satagaj from the Small Business Tax Compliance and Fairness Coalition. Welcome.

STATEMENT OF JOHN SATAGAJ, SMALL BUSINESS LEGISLATIVE COUNSEL, SMALL BUSINESS TAX COMPLIANCE AND FAIRNESS COALITION

Mr. SATAGAJ. Good morning. My name is John Satagaj. I am here on behalf of the Coalition for Fairness in Tax Compliance. I co-chair this with my colleagues at the National Federation of Independent Business and the U.S. Chamber of Commerce.

Bob above mentioned that he has been doing this for 30 years. Mike was telling me he has been at GAO 30 years. I have been doing small business 30 years. So you have a lot of experience before you.

It reminded me, when Bob started his remarks, it is all about perspective. He started out his comments about we are a Nation of honest wage earners. I think of us as a Nation of small businesses and entrepreneurs taking risk, creating jobs, and signing the paycheck of those wage earners. So my perspective on this comes from that perspective, that of those small business that are creating those jobs. We have a few points.

Our coalition is not anti-tax gap. We are here to find solutions to this. But it is important for us that several things happen. No. 1, we have the proper research to understand what the problems are. Mike has mentioned some of the problems that we have there.

That we find reasonable solutions, the ones that do not create burdens, that respect the complaint taxpayer. Do not forget, most of this money is coming in a voluntary system and people are compliant. So what we do cannot hurt the compliant folks. So we have to remember those things as we move forward on this.

And as we look at what we need to do, you will find out, as Mike as already mentioned, we are failing to get the research done that we need to understand what causes the tax gap, why people are not reporting their income. Tax gap studies started in the 1960's. I think GAO published the first report in the 1970's. You can look at everyone of those reports, and I guarantee you almost every one of them says the same thing about we do not have enough research.

It is easy to paint this with a nice broad brush. Tax gap, one solution fits all. It does not work that way. When you get below that level, it is hard to figure all of those disparate and discrete areas, that are the problems in the tax gap and understanding then.

Let me give you one quick example, sole proprietors. We say $68 billion comes from the folks that fill out their 1040, attach a Schedule C and have business income. 21 million taxpayers are sole proprietors. 13 million of them have $25,000 or less on that Schedule C.

What is the problem? Some folks say let us do withholding. 21 million taxpayers, withholding tomorrow. There is one big question, if you are going to do withholding, that no one can answer for me. How many of those 21 million do business primarily with consumers? If you do business primarily with consumers, I ask you, who is going to impose withholding, telling the consumer by the way, when you do business with X, withhold $20 from them? We cannot answer that very fundamental question.

No. 2, if you are going to have a reasonable burden on those folks, on the 21 million, if 13 million of them do $25,000 or less, you are going to have to look pretty carefully at what you impose on them in order to get any sort of revenue. Even if they are the worst tax cheats in the world and they are only reporting half of their income, that is still a $50,000 business. That is a very small business we are talking about here. So you are challenged to come up with a solution.

First, we need the research. Second, we need reasonable solutions that are directed to the problem. And until you understand what the problem is, you are not going to come up with a solution.

Next, about respect. It is easy, and we know how it is here, particularly when we are talking about public policy as opposed to the compliance at the IRS. The tax gap. We are going to use the tax gap at least 20,000 times in this Congress to pay for something. The important thing is that when we work on the tax gap, let us be honest with the taxpayers and work on tax gap initiatives, not on something that is used for another purpose.

A good example of one that has already spun out of control in the last Congress, Government contractors' withholding. The notion was there was a problem there. Well, now all Government contractors have a 3 percent withholding on them. That spiraled right out of control right from the very beginning.

There are going to be proposals that people are going to say we want to use it for PAYGO. But you know what, they are going to call it tax gap closing. And I guarantee one that is going to be called that way, a proposal to repeal LIFO. It came up in the last Congress and I bet it will come up in this Congress as a PAYGO for something. And somebody is going to get up on the Senate floor, one of you is going to say, you know what, let us close the tax gap and repeal LIFO. LIFO is a legitimate concern. If you choose to look at that, look at it for that purpose. But do not call it tax gap closing, because it is not tax gap closing. There are honest taxpayers out there who have been relying on this for years in order to do this.

What we need to do is get the research, get the reasonable results, and let us respect the compliant taxpayer in the process.

A couple of last things—

Chairman CONRAD. Maybe I could just stop you on that point because I am sure there are people who are listening who wonder what is LIFO about? That is last-in first-out accounting for inventory.

That is important to say to people who might be listening and wondering what is about.

Mr. SATAGAJ. Good point. And it is one that obviously is allowed under the tax code.

Chairman CONRAD. I think we should make very clear, you are right, that does not have anything to do with the tax gap, because that is in law. What we are talking about here is people who are not obeying the law.

Mr. SATAGAJ. Exactly. And that is my point exactly, is that we need to have the discipline. When we are talking about the tax gap, let us stay focused on the tax gap and respect the compliant taxpayers.

The last point I would like to make is about the size of the tax gap. Bob started out by saying it was $345 billion. It could be bigger.

I started out $345 billion, it is actually $290 billion. It is smaller because there is a net amount that you could collect $55 billion really is a timing issue and so forth. So it is actually smaller than the $345 billion from a starting point then we discussed there.

So in conclusion, we are here to work with everybody. We want to work with all of you here on Capitol Hill, in Congress, work with the GAO. We have met numerous times already with the IRS and Treasury looking at identifying the research that we need, what kind of solutions we can come up with that meet those things.

We can do this, but there is no short-term solution and this is not going to happen overnight. It is going to take a lot of work on all of our part.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Satagaj follows:]

STATEMENT OF

JOHN S. SATAGAJ
CO-CHAIR

THE COALITION FOR FAIRNESS IN TAX COMPLIANCE

BEFORE

THE COMMITTEE ON THE BUDGET

UNITED STATES SENATE

JANUARY 23, 2007

FOR A HEARING ON

THE GROWING TAX GAP AND STRATEGIES FOR REDUCING IT

My name is John S Satagaj, and I am the President and General Counsel of the Small Business Legislative Council (SBLC)*. I am appearing here today on behalf of the Coalition for Fairness in Tax Compliance (CFTC). I co-chair the coalition with my colleagues from the National Federation of Independent Business** and the United States Chamber of Commerce.***

Today, my goal is to address several important issues regarding the tax gap. First, I will talk briefly about the CFTC and its mission in addressing the tax gap. Second, I will share CFTC's perspective of the tax gap data and point out areas where the data can be improved in order to allow for better-targeted proposals. Third, I will illustrate a small component of the tax gap by examining the underreporting of sole proprietors and the limited information we have in this area to address the problem. Fourth, I plan to discuss the role that enforcement, education, and simplification can play in closing the tax gap. Finally, I will recommend using caution against harming the compliant taxpayer at the expense of resolving the tax gap.

THE COALITION AND ITS MISSION:

The CFTC was recently formed in response to efforts by the executive and legislative branches to address the "Tax Gap," the difference between what the federal government is owed in taxes and what it is actually paid. While it is the position of the CFTC that every individual and business should pay in a timely manner their fair share of taxes, and those taxpayers that do not fulfill this obligation place compliant taxpayers at a disadvantage; regulatory and legislative strategies to collect outstanding obligations can place excessive and obtrusive burdens on the backs of honest taxpayers.

Honest small business taxpayers are especially at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture the few "bad actors" that do not fulfill their tax obligations. Small businesses already bear a disproportionate share of the cost of regulation.

The CFTC is a coalition of small business organizations that will fight for the rights of these honest small business taxpayers as the executive and legislative branches develop strategies to address the "Tax Gap." It is the mission of the Coalition for Fairness in Tax Compliance to fight for the rights of tax compliant small business owners by:

- Supporting the accurate use and collection of information on the source, size, and scope of the problem of tax non-compliance that forms the foundation for policy decisions.
- Supporting targeted, sensible, regulatory and legislative measures that will reduce tax non-compliance without generating undue burdens on the general small business community.
- Encouraging tax compliance by developing tax simplification proposals for sections of the tax code that are confusing and complicated.
- Opposing regulatory and legislative strategies proposed by lawmakers in an attempt to increase tax compliance that impose excessive and obtrusive burdens on honest small business owners.

We are eager to facilitate a dialogue. To that end, we have established a website at www.taxcompliancefairness.org.

WHAT IS THE TAX GAP?

Before we can begin a discussion of the causes of the tax gap and potential solutions, the first step is to establish the magnitude of the gap. The Internal Revenue Service (IRS) has estimated the "Tax Gap" to be approximately $345 billion. However $55 billion of this amount is eventually collected. It is just a timing issue. The appropriate starting number is $290 billion.

Other than making that point about the magnitude, we will leave it to others to argue about the size, or even the existence of the "Tax Gap." We are prepared to deal with it as a reality. Whatever the actual number, the "Tax Gap" covers a broad spectrum of business activities and tax compliance activities. The sources of the gap, and therefore the possible solutions for improvement, have to be understood and evaluated as discrete, and often disparate, situations. One solution does not fit all.

Underreporting by individuals has been identified as a problem area. According to the IRS figures, $56 billion is attributable to **non-business** income. Half of the $56 billion is attributable to "other" **non-business** income, the other half is scattered among nine different income categories.

Underreporting by individuals of business income is estimated at $109 billion. Some $68 billion is attributed to underreporting by sole proprietorships. Rent and royalties underreporting is measured at $13 billion and underreporting by partnerships and S corporations is measured at $22 billion.

Overstated deductions by individuals are estimated to contribute $32 billion to the tax gap.

Underreporting of income by corporations is estimated at $30 billion, with $25 billion attributed to large corporations and the remainder to small corporations.

Underreporting of employment taxes is estimated to contribute $64 billion to the "Tax Gap." However, that estimate is largely dependent on the re-characterization of the underreported income by individuals as earned income.

When you look at the information available, two observations immediately jump out. The aggregate "Tax Gap" is simply a collection of dozens of tax-compliance functions, business activities, and taxpayer profiles which have little or nothing in common. Solutions must be up to the task of yielding tax revenues without placing a disproportionate burden on the affected taxpayers. Second, the data and research necessary to make informed decisions does not appear to exist. There are so many questions we need to answer before we can begin to craft solutions that will be effective and not burdensome.

SOLE PROPRIETORS, FOR EXAMPLE

Both observations noted above can be illustrated by examining one component of the "Tax Gap"—underreporting by sole proprietors. Small businesses organized as sole proprietorships are unincorporated business. For tax purposes, the income from their business "flows through" to their personal income tax calculations. They report their income on the Form 1040. The business income and expenses are reported on Schedule C, a form that accompanies the Form 1040.

As noted above, the "Tax Gap" report issued by the IRS identifies underreporting of income by Schedule C filers as a significant source of the "Tax Gap." What do we know about them?

In tax year 2004, 20.6 million individual tax returns reported non-farm income on the Schedule C. Approximately 13 million of these businesses had gross receipts of $25,000 or less. This is an important point that I will come back to with regard to realistic, not burdensome solutions.

Of the 20.6 million returns, the number with any net income was 15 million. Of that number, 3.7 million filed on a Schedule C-EZ, meaning they had business expenses of $5,000 or less, used the cash accounting method; had no inventories; did not report a deficit from the business; had only one business as a sole proprietor; had no employees, did not itemize depreciation; claimed no deduction for home business expenses; and had no prior year disallowed passive activity losses from business.

Although we do not know much about the causes of the "Tax Gap," there is already some discussion of solutions such as more third-party reporting or the withholding of tax from income payments. I generally hold to the axiom, "Don't ask a question that you don't know the answer to." I will break my rule today. Do we know if there is a difference in underreporting in business to business transactions versus consumer to business transactions?

As you know, businesses that engage the services of sole proprietors have to issue a 1099 for amounts over $600. For years, the debate has focused on business to business (B2B) service transactions. Some suggest the current information reporting system is not working. What is the problem with the current system? Are the bulk of B2B transactions under $600? Or is there a failure to file 1099s? Are there statistics on the amount of underreporting when 1099s have been issued? For that matter, do we know how many sole proprietors receive a 1099? How many receive multiple 1099s? Can we break that information down by business activity? It seems to us if we had answers to some of these data questions, we might be able to get a better handle on the sole proprietor underreporting situation.

In recent years I have come to think the underreporting problem, to the extent it may exist, might be more prevalent in the direct consumer to business transactions. In such situations, there is no information reporting, and it does not lend itself to withholding. But, I have not seen an analysis that drills down below the generalization that sole proprietors underreport.

If a sole proprietor is primarily engaged in providing services to consumers, it will be difficult to impose a "traditional" income reporting and/or withholding requirement to close the "Tax Gap." As the recipient of the service, a consumer would be the party required to report or withhold. On a theoretical level, it is not likely this kind of new tax compliance burden would be well received. On a practical level, the number of transactions could be astounding. Without knowledge of how many sole proprietors provide services primarily to business or primarily to consumers, different solutions to closing the tax gap will have to be identified and developed. So I circle back to my questions: How many of the approximately 21 million Schedule C filers are engaged primarily in transaction with consumers?

When you look at some of the business activity sectors of sole proprietors, it also raises the question of whether one solution fits all.

Selected Sectors	Number of Schedule Cs
Construction	**2.6 Million**
Specialty Trade Contractors portion	2.1 Million
Wholesale Trade	**350, 0000**
Retail Trade	**2.4 Million**
Non-store Retailer portion	990, 000
Miscellaneous Store Retailers portion	551,143
Real Estate	**1.2 Million**
Transportation	**980,000**
Finance and Insurance	**670,000**
Professional, Scientific, and Technical	**2.9 Million**
Legal Services portion	353,000
Accounting Services portion	407,000
Architectural, Engineering portion	291,000
Management, Scientific, Technical Consulting portion	735,000
Administrative and Support	**2 Million**
Health Care and Social Assistance	**1.8 Million**
Ambulatory Health Services (e.g. doctors' offices) portion	869,000
Child Care portion	694,000
Arts, Entertainment, and Recreation	**1.1 Million**
Other Services	**2 Million**
Personal & Laundry Services portion	1.3 Million

Another way to look at the sole proprietor sector is by size based on net income. The following are the top three sectors.

Total Sole Proprietorships Net Income	**$247 billion**
Top Three Sectors by Aggregate Net Income	
Professional, Scientific, and Technical	56.9 billion
Health Care and Social Assistance	42 billion
Real Estate	27.9 billion

Again, at the risk of repeating myself, what I see in those statistics are a lot of sole proprietors potentially providing services to consumers. How can we consider solutions such as third-party reporting or withholding until we have a firm understanding of how large a role a consumer plays in the transaction?

As an aside, I thought it interesting that the Information Reporting Program Advisory Committee (IRPAC), the group that advises the IRS on reporting burdens, recommended that the reporting threshold (currently $600 on a Form 1099 Misc.) for health care professionals should be increased to $5,000. The IRPAC said, "We believe this change in the reporting threshold will not adversely impact the tax gap since it is our understanding, and our expectation that most, if not all, of the medical providers are compliant taxpayers. This understanding is based upon the nature of the business that they conduct as licensed and regulated medical service providers."

I do not know if their conclusion is correct or not, but if you look at the tables above, this sector is a rather large segment of the sole proprietor community by number or by net income. It is hard to reconcile these various observations without a comprehensive research analysis.

The sole proprietor sector is just one example. I believe you will find we really do not know enough yet about the causes of underreporting to craft solutions.

ENFORCEMENT, EDUCATION OR SIMPLIFICATION

Now, as I promised, back to the gross receipts statistics for sole proprietors. Thirteen million are reporting less than $25,000 in gross receipts. Thirteen million. When I look at the number what comes to my mind is that we cannot "audit our way out of this." Yes, there will be anecdotal information about the need for better and more audits, but there is simply no way we can allocate the resources to reach the very taxpayers whom the aggregate "Tax Gap" data has identified. This would suggest we need to find non-enforcement solutions.

Even then, when we do identify the causes, we still need to find non-burdensome solutions. Thirteen million sole proprietors with less than $25,000 in gross receipts. Even if we make a wild assumption that they are only reporting half of their income, what solutions can we find that will produce new revenues that won't impose extraordinary burdens on the smallest of small businesses?

Taxpayer education must remain one of our primary tools. We believe the IRS has made significant headway since it was given the mandate almost a decade ago to pursue more aggressive education outreach. It will take a long time to reach the 20 million or more small businesses (indeed as most of us in the trade association world know, one cannot get discouraged about how many we reach with our message), but we would submit it is not only appropriate, but essential that we continue to try. Success is hard to measure but I suppose, ultimately, if we can get the "Tax Gap" reduced, and education is a primary component, then we know we have been successful.

I would be remiss if I did not state again our belief that tax simplification **would** reduce the "Tax Gap." For small businesses, particularly the sole proprietors, the challenges of divining the purpose and meaning of the tax code are formidable. Does the IRS have any figures on how much income is underreported because people do not understand the tax code? It is important to understand why there is noncompliance with the tax code. The complicated and often contradicting laws that make up the tax code form a barrier in many cases to compliance with the tax code. Inadvertent errors and confusion are often caused by complex laws. These same complex laws also contribute to intentional noncompliance. Many who do not understand the tax code may perceive unfairness in the code. Studies have shown that these same people use this feeling of unfairness to justify their noncompliance to themselves.

RESPECT

Finally, it is incumbent upon all of us to make sure we treat the compliant taxpayer with respect. After all, the vast majority of our revenues are collected through voluntary cooperation with a high compliance rate of 86 percent. It is important that we reserve the label "Tax Gap" for only those proposals which are truly related to addressing the "Tax Gap." We fear we will see various revenue offsets labeled as "Tax Gap" closers. In many cases, the revenue offsets alter long time policies upon which compliant taxpayers have fairly and honestly relied. What message do we send to the compliant taxpayer to label these items as "Tax Gap" closers?

Conversely, we must make certain "Tax Gap" initiatives are enacted for that purpose, not for the sake of revenue raising. A prime example of a "Tax Gap" initiative that spiraled out of control was the enactment of withholding on government contractors. A lot of compliant taxpayers got pinned with a cash flow penalty under that proposal in the name of "closing the tax gap."

In conclusion, we look forward to working with the Administration, Congress, and others to understand the nature of the "Tax Gap" and to find reasonable, effective non-disproportionately burdensome solutions. However, we view this challenge as a long-term project.

Thank you.

* SBLC is a permanent, independent coalition of nearly 60 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views.

**NFIB is the leading advocacy organization representing small and independent businesses. A nonprofit, nonpartisan organization founded in 1943, NFIB represents the consensus views of its members in Washington and all 50 state capitals. NFIB's mission is to promote and protect the right of our members to own, operate and grow their businesses.

***The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Chairman CONRAD. Thank you, Mr. Satagaj, and thank you for those constructive thoughts.

Just on the question of how big the tax gap is, I believe it is much larger than $345 billion because I have looked into how they made the estimates. And I do not want to bore people with the details of how that was done. But I think honestly if you evaluate the way they made the estimates, the likelihood is the tax gap is substantially bigger.

First of all, that is a number from 2001. We are in 2007. If we look back historically, we have seen that the tax gap has grown inexorably and, in fact, has exploded in recent years.

Second, if you talk to people in the accounting profession, they will tell you that what we call aggressive accounting has increased geometrically. That is because of competitive pressures, accounting firms have become much more willing, if not eager, to engage in very aggressive accounting practices with respect to taxes that are due.

Let me just go to the question I would ask each of you. If you could give two ideas that would make a meaningful difference with respect to the tax gap, what would they be? Mr. McIntyre?

Mr. MCINTYRE. Well, if I only had two things, No. 1 would be to get more information from the tax haven countries about our people and corporations who have activities there or pretend to have activities there.

And second, a very substantial increase in the IRS budget for enforcement.

Chairman CONRAD. All right. Mr. Brostek?

Mr. BROSTEK. I would first encourage more information reporting. Although I do not have a laundry list of things that would necessarily bring $300 billion down to zero, if we get information reporting on various types of income, it will achieve high levels of compliance, as we have seen.

I would also look for opportunities to simplify some of the complex provisions that help people who would like to cheat figure out ways of doing so and that confuse honest taxpayers.

Chairman CONRAD. OK. Mr. Satagaj?

Mr. SATAGAJ. There are two things. One is taxpayer education. We started on a road in 1998 to encourage better education and outreach to the community. If you work with small businesses, you know it is hard work to get the message out. You have to repeat it time and time again and over and over. And we are still not reaching the level we can. We can do better on that.

Tax simplification, of course, is a way I believe that we can get more folks in there because there are still is a lot of folks who say, you know what, this is too complex and I am not doing the job. And so I think those two things could go a long way to helping us.

Chairman CONRAD. Let me ask you this question, and ask each of the witnesses. How about tax reform? We have a tax system that was largely constructed in the 1930's, the 1940's, and the 1950's. The world has changed. We have, I think, what is clearly a growing tax gap which raises questions about the efficiency of the underlying system. How much emphasis would you put on fundamental tax reform in order to achieve a result? Mr. McIntyre?

Mr. MCINTYRE. If we could take the tax system back to say where it was—at least on the base—after the 1986 reform act, that would help a lot. Since then we have added all kinds of new special tax breaks, made the tax forms finer and finer print to fit because of all of the extra lines. And that has annoyed the honest taxpayer and created opportunities for those who would like to be less than honest. So that would help.

But perhaps most important about that kind of a tax simplification reform effort would be to correct a growing problem. You have the IRS running half of the Government these days, it seems like. Health care, education, savings policies. They have to do all of these things. That is not what they are supposed to be doing. It is not what they are trained to do. They are supposed to be collecting revenues fairly and efficiently. If they could get back to their real job, they would do a much better job of it.

Chairman CONRAD. Mr. Brostek, what would you say about this question of tax reform as an essential component?

Mr. BROSTEK. I do believe that tax reform should be part of the strategies that are pursued for reducing the tax gap, in part because if we are able to make the code simpler, reduce the number of credits and deductions and exclusions from income, we can have lower tax rates. And the lower the tax rate is, the less incentive somebody has to escape taxation. It would also help us raise revenues efficiently in the economy.

I would also point out that tax reform is not necessarily synonymous with high levels of compliance. One of the things that is sometimes thought about when tax reform is discussed is moving to a consumption tax. Consumption taxes can have high levels of noncompliance, as well. The National Audit Office in the U.K. has estimated that their value added tax has had a tax gap of about 15.7 percent. That is roughly what we have in this country.

So reform itself can be helpful, but it is how that reform is done. We really need to have transactions transparent to the tax administrator in order to have tax reform work well.

Chairman CONRAD. Mr. Satagaj?

Mr. SATAGAJ. I have already tipped my hand because I mentioned tax simplification as one of the ways I think we do a better job, and that is fundamental to tax reform. I think you do have to be a little careful of the difference between tax reform and tax simplification.

As Mike has already pointed out, you can get tax reform without actually simplifying. I think the important point is the comfort level of the taxpayer has to be high enough, whatever system you have, that they are willing to be compliant at the levels that they are currently compliant.

Chairman CONRAD. Let me just say on the point that Mr. McIntyre made, we have a building down in the Cayman Islands, one building, a five-story building, that is the home to something like 8,000 companies.

Senator GREGG. Do you have a picture?

Chairman CONRAD. I do, it is on its way.

This building is home to some 8,000 companies all claiming they are doing business out of that building. I have said it is the most efficient building in the world, a very modest building. But an amazing amount of business activity out of that building.

I think, Mr. McIntyre, you have hit on something here with respect to information from tax haven countries. There is tremendous leakage in those countries. When I was tax commissioner in my State, and for a time the chairman of the Multistate Tax Commission, I followed the transactions of one multinational corporation and found that in the sale of grain, that grain had changed hands eight times before it left this country and then went offshore. The last I was able to follow it, it was down in the Cayman Islands, selling from one company to another. It was amazing, no taxes reported in this country, and although they showed tremendous profits in the Caymans, no taxes there because they did not have any taxes.

I found that when I was tax commissioner, one oil company that showed losses at every step of the marketing chain in the United States, showed huge profits in the Cayman Islands with one employee. Millions of dollars in profits because that is where they showed all of their profits.

Actually, that man is really a hard worker. He is down there producing millions of profits when thousands of employees in the United States produced none.

Look, these are scams that are being run that are really unfair to the vast majority of people who are honest. I think, Mr. Satagaj, you said it well. The fact is most people, I think a significant vast majority of Americans, pay what they legitimately owe. Companies pay what they legitimately owe to the extent they understand it.

But there are a group out there, and unfortunately I think it is a growing group, who think they can get away with murder. And they are shoving the burden onto all of the rest of us.

Senator Gregg?

Senator GREGG. Thank you.

Picking up on that note, obviously better transparency as to what is happening offshore would be very useful. But it does require an international effort. I think Mr. McIntyre made that point. If we do it unilaterally we actually end up disadvantaging ourselves in the international trade. So it has to be done with the Europeans and with the major economies in Southeast Asia. But it should be done, I am 100 percent in agreement with that.

I also have some horror stories I could relate that I am familiar with, as to people avoiding taxes by using those shelters.

So I think that is something that can be done. This committee does not have jurisdiction over that, but it should be done.

Something else that could be done is better reporting basis on capital assets. I think that is clearly some direction we are moving into and it clearly should occur.

I am interested, however, in this question which you have pointed out, Mr. Satagaj, that is basically that unless you have the system that people have confidence in is fair and understandable, you are never really going to get compliance. This goes back to the 1986 act which has been highlighted here as an example of an attempt to make our system fairer and more level, in which a lot of deductions were eliminated in exchange for reducing rates.

I guess I would ask whether or not people think that is a template that we should return to? It has been 20 years since the 1986 act, and we have now recluttered the code with all sorts of new deductions for purposes which are outside the intention of raising revenue.

That initiative, in 1986, I was on the Ways and Means Committee. It was a bipartisan initiative led by Chairman Rostenkowski and the President, with the Congressional leaders being Jack Kemp and Bill Bradley. I guess the question is should we return to that sort of a really major effort to reduce the underbrush and the tax laws and get back to rates that are simpler but collect more revenues because there are fewer deductions that are being used for the purposes of avoiding taxes?

Mr. MCINTYRE. I am obviously for it.

Senator GREGG. That is great. I am impressed that your organization would be for that. I think that is very positive.

Mr. MCINTYRE. I just want to point out that in 1986 we played a major role in getting that bill through the Congress with the studies we did exposing the kinds of tax avoidance that got the public exercised and got President Reagan on board, as a matter of fact, according to his Treasury Secretary at the time.

So yes, 1986 was the right direction. It had one flaw which was easily corrected, that it did not raise enough money to pay for the Government. But that is just a rate issue. That is what we need to do, establish a tax base like 1986, with rates sufficient to pay for what we spend. What we spend and what we take in are obviously two important questions. But whatever you decide to spend, you ought to pay for it.

Senator GREGG. Mr. Brostek?

Mr. BROSTEK. I think that broad template is quite reasonable to return to. It is not that there cannot be legitimate tax deductions and tax credits. There can be things that are done well and efficiently through the tax code. But we certainly think that the growth of these special provisions ought to be reviewed. And we ought to make sure that the provisions we have are accomplishing a purpose at a reasonable revenue cost.

Mr. SATAGAJ. Obviously, I agree. One of the important things, though, is you have to decide—which is just what Mike said. You have to decide what is the purpose. Not a purely neutral system. But our current tax code does have some purposes and we reward, for example, home ownership as important. And if you go into a tax reform debate, you need to decide that. Are we going to accomplish some goals in addition to just raising revenue?

And that is the big challenge of sorting that out. Once you get that decision made, it becomes a little easier how or where you go. But the notion that you are just going to do this to raise revenue, I do not think, is an acceptable starting point.

Senator GREGG. I appreciate all of your comments. I would like to see us move in that direction.

Another ancillary point that has been made here is the accounting firms. We are down to four major accounting firms in this country, and that has been a function really of reform. We have essentially reformed our way out of accounting firms and competition amongst accounting firms, and therefore we do not have any accounting firms left.

I guess my question would be to you, do you think having more accounting firms and some competition there would create a better atmosphere? Or are four major firms doing all of the audits in this country the way to do it?

Mr. SATAGAJ. I will wear my entrepreneurial hat. I would like to see more small accounting firms. I think obviously that small businesses—are not going to the big firms anyway. They need good accounting advice and so I think it would be very helpful.

We have talked about it. Commissioner Everson has been very aggressive in a lot of areas as it relates to tax shelters and the like. We have a lot of work being done in that area. But it is what we do with the small businesses and the advice we give them that I think is important. And I think some more activity in that area is a plus in my book.

Mr. MCINTYRE. It would be nice to have some more accounting firms that were less ethically challenged than the current four.

Senator GREGG. I would be interested in your thoughts on how we do that in the context of today, when you require size in order to basically meet the amount of compliance that we put on these firms.

I guess my last question would be in the context of the 1986 act, was the Breaux-Mack Commission, did they put forward some ideas that would lead to some better compliance? Or do you reject their ideas? Because that is the most recent major tax commission.

Mr. MCINTYRE. They had some fundamental problems. They had a $7 trillion add-on to the deficit over the next 10 years. But beyond that, on the international area they said they were going to make it harder for the IRS to get compliance. So I was very disappointed in that effort, as well. It was not that fine of a piece of work, in my view.

Mr. SATAGAJ. I do actually. Chairman Rossotti was on that commission, as well. There is actually a large small business component to what they proposed. And intriguingly, it actually promotes more of a cash accounting system but it provides incentives to go to that. And it is a little bit about the transparency.

I think those of us in the small business community, maybe we would be willing to give some more transparency in return for something that makes our life easier. If you could get to cash accounting and in return you did have to make some more transparency, that would be good.

A lot of folks do not look at the small business proposal in the Breaux-Mack Commission's work. But there are some interesting thoughts about how you work with the small business community to make it simpler but more transparent.

Senator GREGG. Thank you.

Chairman CONRAD. Given the number of senators here, we are going to go to 5 minute rounds to accommodate as many Senators as we can.

Senator WYDEN.

Senator WYDEN. Thank you, Mr. Chairman. This has been an excellent panel. I have been particularly pleased because, having introduced the fair flat tax reform which modernizes the 1986 act by closing loopholes so that you can lower rates, I have been really pleased with the response that you all have given this morning.

Ever since I introduced that legislation, when witnesses show up they all say we ought to try to update the 1986 kind of concept. But gosh, everyone says it cannot ever be done. The newspaper reporters are always describing it will not happen, this is a lonely crusade that this fellow from Oregon has taken on.

What I found striking this morning is you all have given us a way to jumpstart the effort to close the tax gap and also do tax reform. And that is through tax simplification.

There have been 15,000 changes in the tax code since the last reform. It comes to three for every working day over the last 20 years. People spend more to fill out forms than our Government spends on higher education.

I have a one page 1040 form with 30 lines in my Fair Flat Tax Act. Senator Gregg mentioned the Breaux-Mack Commission. Their's is about seven lines longer. For purposes of Government work, it is a no-brainer to put the two of them together.

I just want to go down the row and ask, we can start with Mr. McIntyre, would it not make sense to come out of this hearing and say the next step that could promote common ground—and I note, Mr. McIntyre, you have been trying to do that with your cleanse the code effort, and I have been glad to be part of it—would it not make sense to come out of this effort and say let us go now to tax simplification and use it to jumpstart a real plan to close the tax gap and to reform our tax law?

Let's start with you.

Mr. MCINTYRE. I am certainly in favor of the outlines of your tax reform plan. I have a couple of quibbles, but very few. So if we could find a way to move that forward, and if this was a good way to make that happen I would be in favor of it.

My big caveat is I cannot figure out how any good tax reform could be signed by the current president of the United States. So it makes me very nervous that we would end up with something bad.

Senator WYDEN. I told the President that another tall Democrat on the Senate Finance Committee named Bill Bradley wanted to work this out, as well. My jump shot is not as good as a Bradley's, but I still think the spirit of 1986 can be replicated.

Mr. MCINTYRE. There is one difference. When Ronald Reagan read our corporate studies, finding out that General Electric, his former employer, was not paying any taxes, he was appalled and said, "do something about it." When we put out our most recent corporate study, saying that under President Bush's policies 82 companies out of 275 were paying nothing at all, Bush's people said, "is it only 82?"

Senator WYDEN. Mr. Brostek, on starting this with tax simplification, what is your reaction to that?

Mr. BROSTEK. I think that is a good strategy for starting to try to address the tax gap.

Senator WYDEN. Very good.

Mr. Satagaj, I was really pleased to hear your comments today on tax simplification, because I know, having worked with my small business community, that people are just fighting for survival. And so the inclination is to always kind of tinker with the code a little more. But I gather you would be comfortable with that simplification, as well.

Mr. SATAGAJ. Simplification, my caveat is the one I said a few moments ago, you have to buy into a purpose of what you are going to do with the tax code. That is far more difficult. It is nice to look at the 1040 and the lines and stuff like that. But if you look, for example, at the rest of the recommendations of the President's Advisory Group, there is a lot of complexity behind that, particularly on the business side. It is not just a little form to fill out. There are a lot of decisions that go behind that.

So is a far more difficult challenge than getting a little consensus that it is time to clean up. It is getting the consensus on the purpose that is far more important.

Senator WYDEN. Mr. Chairman, I would just note that a number of us here serve not just on this committee but on the Finance Committee. Given the number of witnesses that constantly come up and say you have to drain this swamp, I think we need to do something. One member of the Senate Finance Committee told me, "I do not really know about your bill as it relates to every provision. But after 20 years, this has just gotten out of hand. We have to cleanse the code."

And I hope, Mr. McIntyre, that your group, the Cleanse the Code Coalition, can really get out and prosecute the case about what we can do in this country by cleaning out some of the clutter, getting more transparency, closing the tax gap and jump starting us to real tax reform.

I commend all three of you for an excellent presentation. Mr. Satagaj, I am going to be back at you specifically about my legislation.

Mr. SATAGAJ. I look forward to it.

Senator WYDEN. I thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Wyden.

I would like to take this moment to indicate that I am going to form at least two working groups of the Budget Committee, one on health care and one on this whole issue of tax gap tax reform. I am going to ask, on the health care piece of it, that Senator Wyden and Senator Whitehouse lead that effort. I am going to ask, with respect to that tax reform piece of it, that Senator Wyden and Senator Stabenow be involved with that. I would welcome the interest of other members on these two committees. And I am going to indicate that there will be others that we will form.

The magnitude of the challenges that we face are so large that I think we have to establish some working groups of smaller members of the committee to come back to the full committee with specific proposals. I have had long discussions with Senator Whitehouse and Senator Wyden on the whole question of the health care piece of it. I know that Senator Wyden has been especially engaged in that issue, as well as the tax reform. I do not know if it is fair to burden with asking you to also be involved on the tax reform piece.

And Senator Stabenow, you are a member of the Finance Committee. I hope that you would be engaged in that effort.

We will ask Senator Grassley to be involved on the other side with the tax reform pieces, the ranking member of the Finance Committee. On health care, we will ask members on both sides who is willing to put in additional time with respect to those issues.

But I think it is absolutely urgent that we come back with specific proposals and that is what I am going to be asking these working groups to do.

These will not be the only, there will be a number of other areas that we need to address as well, and we will be talking about those in the coming days.

Senator Allard, thank you for your patience, sir.

Senator ALLARD. Thank you, Mr. Chairman, and thank you for setting up this panel.

In this discussion, I think the assumption is that the IRS is the perfect agency and they do not make mistakes and some of the things that they deal with are ignored, as far as performance is concerned.

I do not know whether anybody on this panel has looked at the business system modernization that has been going on at the Internal Revenue Service. But what I see in looking at what shows on paper is that that particular program is not meeting its performance goals. The President, in the last budget, actually had decreased its funding because it was not meeting its performance goals.

Can either one of you comment on the purpose of that particular program, and whether it is working from your perspective or not?

Mr. SATAGAJ. Actually, I am glad you brought that point up because earlier when the Chair asked for a couple of suggestions on how to close the tax gap, I had a third. One of them is the problem in the IRS with its ability to accomplish anything with the information it currently has. For example, if you get into the 1099s and the issue of matching them and do you have the capability to do that?

Right now it is my belief that the IRS is behind in exactly the way you are saying in those kind of things. I remember the first time I saw an IRS Service Center and they had what they called a Gideon table. I do not know if you all are familiar with that, but is a desk with about a zillion little slots that they throw tax returns into.

Well, I saw that in 1985 and it is still in use. They may still have it.

But the notion of the computerization and the modernization and all of that, it has a long way to go yet. There is no doubt about that, in my opinion.

Senator ALLARD. Anybody else looked at that program?

Mr. BROSTEK. Although I have not personally be involved in reviewing that program, GAO has looked at it a number of different times. And it is certainly true that it is well behind the milestones that were originally established and IRS has struggled over a number of years to be sure that it has sufficient management capacity to manage this kind of transformation in their IT systems.

It is also fundamental to getting efficiency improvement in how IRS uses its own resources. The ability to process more information electronically and to analyze it rapidly, is key to then better identifying how to allocate their own resources.

Senator ALLARD. Do you think electronic filing would help with that particular program?

Mr. BROSTEK. I do. One of the things that that allows IRS to do—and give them some credit, they have begun doing this—is to reduce the amount of work force that is doing the kind of things that Mr. Satagaj just mentioned, pushing paper around, and instead use work force that have higher-level abilities to actually figure out who is non-compliant and audit them and get the money that is owed. IRS has been able to close down the paper processing pipeline in a couple of service centers because of the increase in electronic filing. Further electronic filing will help them continue that.

Senator ALLARD. I have run into several individuals who are just starting out in life. They are young families. And the IRS has sent a notice to them that they did not pay enough taxes. One family pointed out and said well, they are claiming I do not have a kid. I said I distinctly remember getting up early in the morning and changing diapers. So do not tell me I do not have a kid.

But to try and correct that, I mean the margin of error on something to correct that form is $85 or $65, it is some amount less than $100. And what their accountant will tell them is, you are better off just to pay the thing instead of fight the IRS on it.

Has anybody ever done a study to find out how much effort is made to collect money from taxpayers who owe under $100? You are getting down to a minuscule amount. On one taxpayer it may not amount to much. If you are just a starting family, it is a fortune. If that happens with 500,000 families, for example that file joint returns, you are talking about $50 million.

So has anybody ever looked at those small collections that the IRS spends time on and enforces? How much enforcement action is put in that particular area? And what do you do about those kind of situations?

Mr. BROSTEK. I am not personally aware of whether a study has been done on that exact issue of how much resources go into these kinds of small dollar issues.

I do know that IRS has various thresholds in pretty much all of its enforcement programs, and they do try to allocate their resources to go after suspected noncompliance that would be worth pursuing.

It is, in part, a speculation on my part, but a situation that you are talking about could be something that is being turned out from their information returns program where they match up information returns. That is a fairly inexpensive program for them, because it is largely computerized. The generation of the notice is computerized. Their biggest expense is when people call in to try and figure out how they can take care of their situation.

So there are some situations where a relatively small dollar amount might still be efficiently pursued by the IRS.

Senator ALLARD. In that electronic program, how does an error like that happen? They did not even recognize the one kid.

Mr. BROSTEK. Again, I do not know what the circumstances were there. It is possible that they had not recorded the Social Security number for the dependent on their tax return, or perhaps made an error in putting that number down on the tax return, and therefore the IRS did not recognize that there was a valid child for the couple.

Senator ALLARD. Thank you. My time has expired.

Chairman CONRAD. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

And first, thank you for once again providing us with a very important hearing that is extremely relevant to what our task is. So thank you for doing that.

Also, thank you for the working groups. As Senator Snowe and I have been working on the issue of health information technology, which I know you are interested in, and Senator Whitehouse and I have spoken about it as well. We are looking at at least $100 billion in savings there if we focus on health IT. So I am hopeful that we might wrap that into what we are talking about, as well. There is tremendous savings there.

Welcome to all of our panelists. Thank you for your thoughtful information. Particularly Mr. Satagaj, I want to welcome you representing small business. You are, I know, connected with the association of a dear friend of mine, Peter Perez. He certainly keeps me focused on what small businesses are concerned about.

Mr. SATAGAJ. Me, too.

Senator STABENOW. So I appreciate your being here.

I did want to look from a broad perspective at what we have heard today because I am very concerned about what this means for middle income families, small businesses, the majority of people in our country.

Mr. McIntyre, you said that the largest cause of the enormous deficits has been the drop in personal income taxes, about 28 percent, again the highest income individuals less likely to be a wage earner, more likely to be a non-wage earner, a 28 percent drop. The lowest, in terms of revenues as a share of GDP, in the last 55 years.

But then when we look at that and then we look at also your testimony saying that it is actually a wage earner, a person who gets a paycheck, which is the majority of Americans, who are most likely to file their taxes, the most honest in that sense of filing and reporting and so on. And that where the challenge is are non-wager earners whose income comes from stocks, real estate annuities, foreign income and so on, where there is more of a challenge in under reporting for reasons whether that is on purpose or not. And it may not be.

But it shows a picture, Mr. Chairman, that is of great concern to me about what is happening to the majority of Americans who did not receive a benefit from the tax cuts, are paying their taxes dutifully. What they get from the bargain is less resources for their children's school or access to college or challenges around health care or whatever.

And yet we see of the $350 billion, or whatever the number is, that if everyone was paying their fair share, we would in fact be investing in things that all Americans believe are important for quality of life. So I think this is a critical, critical issue.

In terms of enforcement, Mr. McIntyre, I'm wondering if you are recommending that the majority of enforcement go to non-wage earners? It seems to me we hear about a lot of folks, middle income families and so on, the IRS issues related to working folks. Are you recommending that, in fact, we change the focus more toward those individuals based on this picture that represent the majority of noncompliant taxpayers?

Mr. MCINTYRE. Yes. The increase in enforcement that is needed the most is going after these upper income people and large multinational corporations that are moving income and profits offshore. There are other tax shelters that need to be investigated, too, and Senator Grassley has exposed a number of those. But the offshore situation is the worst. And I can tell you that it is not your average wage earner engaged in these abusive practices.

Senator STABENOW. Absolutely.

When you mentioned the penalties when you were speaking, increasing penalties, could you give an example of what kind of increase, which you would recommend as it relates to penalties to address these kinds of things?

Mr. MCINTYRE. For instance, we have some penalties for tax preparers that intentionally file wrong returns for people. Some of them are only $50 or $100. With an audit rate now in the 0.8 percent range, and clients that will pay you to help them cheat—some will, anyway—well, it is just not enough because you are not going to get caught very often. So if the chances are one in 100 of getting caught, we want a penalty that is very severe, not $50 or $100 but thousands of dollars. Maybe that will scare some of these people.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Stabenow.

If I could just put up the—on the question Mr. McIntyre was just raising, here is now the picture of the building in the Cayman Islands. I was wrong. I think I said 8,000 or 10,000.

Mr. MCINTYRE. They probably got 4,000 more in the time you had to get that put together.

Chairman CONRAD. 12,748 companies call this building home. Looks like a relatively modest building but it must be wired with the latest technology to have 12,000 companies doing business out of this building.

They are not doing business out of this building. They are engaged in a tax dodge out of this building. And that is precisely what Mr. McIntyre is referencing when he is talking about these offshore tax havens.

Frankly, if you look at the estimates that the IRS has for the tax gap, I think this is where they really missed the boat. I think tens of billions of dollars are being flushed through these tax haven operations and it is really terribly unfair to the vast majority of honest taxpayers in this country.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Mr. Satagaj, I assume that the Chairman's picture, where you have 12,000 businesses crammed into a five-story building, is not the type of small business that you are representing?

Mr. SATAGAJ. I was thinking that. I am pretty sure none of our members are one of those occupants.

Senator WHITEHOUSE. When you all talked about the idea of requiring substantially increased enforcement, I could sort of feel a chill emanating across the country from this committee room as people who spent—we heard from Chairman Bernanke—an average of 27 hours coping with the filling out of their tax forms. The ordinary wage earner these days probably has two jobs and also moonlights, so it is a little bit more complicated. And I think there are a lot of Americans who have the sense that if the IRS really came after them, somehow or other they would probably be able to find something just because it is so complicated.

So the idea of additional enforcement, I think, carries some real hazard in terms of public acceptance. And in terms of dealing with that question, I am interested in having you quarter up a little bit more the question that Senator Stabenow raised, which is the focus of that additional enforcement will fall into four rough categories: major corporations, small businesses, high net worth individuals, and ordinary folks. Roughly, where do you think the $350 billion or more, specifically the $100 billion that you think is readily collectible, where does that fall in rough numbers into those four categories of corporate and individual taxpayers? Or non-taxpayers, as may be the case.

Mr. MCINTYRE. The offshore area, which is my primary focus here, is all upper income, very upper income people and large corporations. So those are your two areas that I think should be the focus. I think that is where there is a huge amount of money.

Senator WHITEHOUSE. Out of the $100 billion, what would the amount be that you would guess relates just to the offshoring?

Mr. MCINTYRE. There is probably $100 billion in those two alone, according to estimates. Nobody knows for sure because these things are all secret. But we do know that there is $11 trillion in offshore accounts worldwide, which at some reasonable rate of return is probably earning something like $1 trillion in income every year. And the United States share of that is probably close to half.

So that is $500 billion on untaxed money right there that, even at a 20 percent rate, is $100 billion.

Senator WHITEHOUSE. So the average American taxpayer can feel reassurance that if we double the enforcement, there is not going to be somebody knocking on their door?

Mr. MCINTYRE. The average American taxpayer wants the police to go after criminals. If you told the average American that we were going to hire some more policemen because there is a crime wave going on in your neighborhood, they will be happy about that, not sad.

Well, we have a crime wave going on among people who are very respectable and very wealthy and very prestigious, but they are not the average American.

Senator WHITEHOUSE. Thank you.

Mr. BROSTEK. I am not sure that I can give you a clear answer on how to quarter this up.

I agree with the point that we really do not know well, for these overseas transactions, what the level of noncompliance is. It is an area that is very difficult to study because of the transparency issue that we talked about before. If somebody is trying to hide something, it is difficult for IRS to get behind that, particularly when you are talking about sovereign nations. There does seem to be a potential that there are big dollars involved. We are pleased that IRS has been trying to put some emphasis into trying to figure out how to tackle that.

Small businesses, for the universe that IRS has the best measurement of, which is the individual income tax, small businesses do stick out as one of the noncompliant groups, in general. It is a tough problem, given what Mr. Satagaj was talking about. There are millions of really small businesses. It all adds up to big dollars but you are talking about a lot of small dollars to go after.

And from the taxpayers' perspective, one of the things that was mentioned earlier is that small businesses are less than 50 percent fully compliant. That means that those who are compliant are competing against a business that has an unfair advantage. And that can be a substantial unfair advantage.

So I think that is part of what IRS needs to take into account.

Senator WHITEHOUSE. Mr. Chairman, I think that it is important to get after this. And just from my own personal experience, I can remember as U.S. Attorney running an FBI investigation that ground to a halt, probably in a building very like yours, where the FBI, pursuing a criminal matter, simply could not penetrate the multiple veils of Cayman Islands offshore corporate shells in pursuit of a criminal case. So to ask the IRS to do it more effectively without further help from this committee, I think is a tough burden to put on them.

Chairman CONRAD. I think the Senator makes a very good point and a powerful point.

That this thing is going on right before our eyes, it is inexcusable really. Mr. Satagaj, you are here representing small business. I come from a small business family. My family was in the printing and newspaper business. They paid their taxes. And it was not always comfortable to do so. But to have this kind of scam going on, were others just evade and avoid what they legitimately owe and stick the rest of us with the bill, this just cannot be acceptable.

We have to find a way to aggressively go after this. To have 12,000 companies supposedly doing business out of this building is not credible. It is farcical.

And there are so many other scams. We have a situation now where companies are buying sewer systems—this is true, this is not a joke. They are buying sewer systems in Europe, depreciating them on their books, leasing them back to the cities in Europe that paid for them with taxpayer dollars there. I mean, that is inexcusable, that that kind of thing is going on.

Senator SANDERS.

Senator SANDERS. Mr. Chairman, thank you for holding this very important hearing.

I just came, and the reason that I was late is I came from a meeting of the Veterans' Committee where some of us believe that the VA is grossly underfunded, that our veterans are not getting the health care and other benefits that they need. One of the reasons is that there is presumably not enough money available.

So this is not some kind of abstract issue. This is a question of whether children get health care, veterans get the benefits that they need. And it is absolutely appropriate for this committee to take a hard look at why people who have the capability are intentionally avoiding paying what they are supposed to be paying in taxes according to the law.

I just have a few questions. According to a recent New York Times article written by David K. Johnson, he says—and I quote— "Top officials at the IRS are pushing agents to prematurely close audits of big companies with agreements to pay only a fraction of the additional taxes that could be collected."

One IRS employee, according to the New York Times, says that when it comes to corporate audits the IRS is "giving away the store."

Another describes the corporate audit process as "catch and release."

I would like to ask Mr. McIntyre and Mr. Brostek if they believe that the IRS is doing all that it can in collecting corporate taxes? And if not, what do you believe that they should be doing. Mr. McIntyre?

Mr. MCINTYRE. I think it is a question of resources, not a question of intent on the IRS's part. As the auditors told the New York Times, they are not doing as much as they should be doing.

Last September GlaxoSmithKline settled a long-running tax dispute with the IRS for $3.5 billion, which is a record settlement. Great, except that the IRS pointed out they actually owed $15 billion. So they were only paying 23 cents on the dollar. That is the kind of thing that you were talking about from those New York Times articles, that they just do not have enough people who can sit on these cases and pursue them long enough. So they are doing these fast audits, where they get what they can.

But you were a corporation that for whatever reasons thinks you should not be paying taxes hey, you get caught and you pay back 22 cents on the dollar.

Senator SANDERS. These large corporations, large drug companies, have incredible resources and can hire the best tax people and the best lawyers in America.

Mr. MCINTYRE. Or the worst, depending on your point of view.

Senator SANDERS. Certainly, the IRS does not have that capability. Isn't that our fundamental problem, with a Government agency taking on corporations that have unlimited resources and incredible capabilities of getting the best, or the worst if you like?

Mr. MCINTYRE. These cases, typically once they are discovered, are not that complicated. You do not have to have a graduate degree in tax sheltering to figure out that they are illegal. The deal is that they are covered up so that they are very hard to discover. Once they are discovered, with most of these offshore things, a first-year law student could win the case.

So it is not that the Government employees are incompetent. It is just they have too much work to do, compared to the number of people they have.

Senator SANDERS. Mr. Brostek?

Mr. BROSTEK. I certainly would agree that there is a large audit universe out there that IRS cannot get to with its current resources. There is a decision for Congress to make about how that weighs up against other governmental priorities.

I do not know precisely how this initiative is working that was written up in the article. One of the things that IRS is, I think, trying to take into account is the deterrent effect of auditing more people. And so I think part of their philosophy or their thinking here is we may not get all of the money from some of these corporations that we audit. But if we can audit more of them, have an audit presence across a larger portion of the corporation universe, we may actually improve compliance more than if we go for every—

Senator SANDERS. And one can understand that. But isn't the answer to do both?

Mr. BROSTEK. If you were unconstrained in resources, that would certainly be—

Senator SANDERS. But isn't that a good investment? Here is a case of hiring more staff, which one would think would more than pay for itself if we began to make a dent on some of these issues that the Chairman was talking about. Am I missing something here?

If you could bring in billions of additional dollars hiring a few hundred or even a few thousand more staff would be minuscule compared to what you are bringing in. Am I missing something on that?

Mr. BROSTEK. Your logic is generally sound, yes.

Senator SANDERS. Mr. Brostek, in February of 2004 the GAO found that Department of Defense contractors owed about $3 billion in unpaid taxes as of September 30, 2002 because the DOD had failed to implement IRS collection procedures.

In addition, GAO often "found abusive or potential criminal activity relating to the Federal tax system" through a GAO audit investigation of 47 DOD contractors.

To your knowledge, has the Department of Defense or the IRS done anything to collect these unpaid taxes?

Mr. BROSTEK. I would have to get back to you on that, sir. That is not an area that I was doing the work in. Perhaps I could give you a response for the record.

Senator SANDERS. If you could, please.

Let me ask you another question, sir. In 2004, the GAO found 59 of the largest publicly traded contractors in fiscal year 2001 reported having a subsidiary in a tax haven country. Do you believe that companies with offshore tax havens have an unfair advantage over companies that do not in competing for Government contracts? If so, what can we do to correct this problem?

Mr. BROSTEK. As I recall, the conclusion in that report was that the contractor who had an offshore presence in a jurisdiction that had a low tax rate could have a cost advantage over a purely domestic contractor. We did not have a recommendation for how to address that situation and I do not have one for you today, I'm afraid.

Senator SANDERS. That is something that we should be—yes.

Mr. McIntyre, in your testimony, you gave us a number of options to consider that would reduce the tax gap, ranging from cracking down on offshore tax shelters and stock option abuse to increased reporting requirements on capital gains and an addition of more IRS auditors. What do you think would be the most important step for Congress to take in making sure the corporations and wealthier individuals pay their fair share?

Mr. MCINTYRE. You could raise tax rates, but that only gets the honest people. So if you are trying to get the ones who are not paying their fair share, then the answer is you need more enforcement. And you also need more disclosure.

Because so much of this tax sheltering is happening offshore, we need to resuscitate an effort that President Bush jettisoned back in 2001 and get these tax haven countries to tell us, and tell Britain and France and Germany and all of the other developed countries, what our citizens and their citizens are doing in those places.

If we get that information, then most of those schemes can be uncovered and people will stop doing them eventually.

Senator SANDERS. What kind of staff increases do you think the IRS needs to do? What has to be done? Do you have any sense on that?

Mr. MCINTYRE. They are down about one-third from where they were 10 years ago in enforcement. So you would need a 50 percent increase just to get back to where you were 10 or 12 years ago. And we are a bigger economy and so forth now.

Senator SANDERS. And more complicated tax laws as well.

Mr. MCINTYRE. Yes. You might talk about thinking about how to double the size of that enforcement staff over a period of time. You cannot do it instantly. It takes a long time to train people and work them in. But that would be the kind of goal.

Senator SANDERS. I presume you have little doubt that paying for that increased staff would more than be balanced by the kinds of revenue that you are bringing in?

Mr. MCINTYRE. It is hard to imagine that it would not be. The IRS has an $11 billion budget and brings in $2.2 trillion, so it is about 230-to-one on the whole process. With incremental—increase in funding, you are not going to get that ratio. But you are going to get $10 or $20 or $30 or $40 per dollar spent, depending on where you put the money.

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

Chairman CONRAD. Thank you, Senator Sanders.

Let me just conclude by asking each of you how much do you think can be reasonably obtained by reform of our current processes: increased reporting, increased withholding where appropriate, increased resources for IRS, tax reform, going after this international tax haven, requiring reporting of those transactions.

How much do you think over a period of time—obviously I am talking 3 years out because you are not going to turn around this ship quickly. But three or four or 5 years out, how much money per year do you think could be obtained by an aggressive approach to this tax gap?

Mr. MCINTYRE. That is a hard question because of the required training of the IRS employees and so forth. But let us say we had not cut back 10 years ago and the IRS still had full manpower. I would think you could be picking up—if you also made some of the changes I've suggested here—$100 billion a year more in a steady state. Maybe more than that if people stop doing these things.

Scaring people out of entering into shelters is even better than catching them after they do it. And that is one of our goals here.

Chairman CONRAD. Mr. Brostek?

Mr. BROSTEK. I really do not have an empirical basis to give you a good estimate there.

One piece of input on that. Commissioner Rossotti, in his last report to the IRS Oversight Board, estimated that—if they had the resources in IRS to followup on all of the cases of suspected noncompliance; where they were pretty sure someone was noncompliant—he calculated that about a $2.2 billion increase in their budget would yield about $30 billion.

Again, we did not audit that estimate. I do not know how reliable it is. But it gives you a sense just from the enforcement perspective, that there would be large amounts of money that could be available.

Chairman CONRAD. Over what period of time was that? Do you know?

Mr. BROSTEK. He was suggesting that the way to approach this, given what we have been talking about, that it takes some time for IRS to gear up, would be—and it was his proposal—to give IRS a real budget increase of 2 percent a year over a number of years. I do not remember the specific number, but it was seven, eight or 10 years in time, to allow them to increase their capacity gradually.

And so that $30 billion would have been after IRS had received these budget increases that he was proposing.

Chairman CONRAD. That would just be on the enforcement side?

Mr. BROSTEK. Correct.

Chairman CONRAD. Frankly, I think there is more money to be recovered on the reporting side by increased reporting that on the enforcement side. I do not denigrate the need to have more enforcement.

But frankly, I think if you had more transparency on these international transactions, but also in reporting on money flows where the IRS then had the ability to match up what is reported versus what is actually happening. I think there is bigger money to be had there.

Mr. BROSTEK. I would agree with you, that if you had the ability to do more transparent transactions, that you are going to obtain higher levels of compliance and probably not need the IRS resources.

In the charts that were shown earlier, if you have information reporting that IRS can make use of, the level of compliance is very high. And it stays high because, in essence, we are auditing all of those transactions every year.

Chairman CONRAD. And that is self-policing in the sense that people know look, everybody is going to know what it is.

Mr. BROSTEK. Right.

Chairman CONRAD. Mr. Satagaj, let me ask you this question, because you are here representing an extremely important constituency group. You earlier talked about how do you do this without hurting the compliant taxpayer, those who are already paying—and they are the significant majority here—who are paying what they legitimately owe or pretty close to what they legitimately owe.

What do you think the tradeoff is here, what could we do that would be seen as fair by small business in terms of increased reporting to get the bad actors—especially on this international side. Very few small businesses are—I would venture to say none of your constituents are over in this Cayman Islands building. I do not think they have offices over in the Caymans.

What do you think? How could this be done in a way that would enjoy the support of the small business community?

Mr. SATAGAJ. We have been looking at it a lot already. As I said at the beginning, we are not against this. We want to find some way and find some solutions.

Do not forget, we are dealing with primarily compliant taxpayers. This is under reporting of income by someone who is in the system. So you do not want a proposal that pushes people out of the system. We will end up with a cash economy, even with the information reporting or withholding, you will push people in the wrong direction.

And we do not know why they are under reporting. You would say yes, well, we can do the information return. But if you are under reporting, are you going to capture the information in an information return? Where is that going?

For example, right now with 1099s—and Mike knows this as well as I do—they require someone to issue a 1099 for $600. That low, that is a pretty small transaction.

Now who are you missing in there, when you are under $600? And why are they under reporting? Is it collusion between two parties?

There is so much there that what my guess is that what you are going to find out—and this is the danger with the information reporting or withholding—is you push people in the wrong direction instead of the right direction. I think we just have to figure out and identify more carefully who is it that is under reporting? And what is the transaction that they are under reporting? We have no sense of that in any of the data or the research that I have seen.

Chairman CONRAD. Let me just say from talking to people in the accounting profession, I will tell you what they tell me, and these are the people who are on the front lines. I have a lot of people that I have worked with over the years who are in the accounting profession. We have had some bad actors in the accounting profession. We have also had some—I used to be a tax commissioner. I can tell you firms that were the gold standard in accounting who I knew were honest and did a good aggressive job of representing their clients. But at the end of the day advised their people to pay what they legitimately owed.

What they are telling me is you have several classes here. You have under reporting, especially in places where basis is an issue. I see all of the witnesses nodding. I think we all know how that works.

If you are looking, especially at real estate transactions, what matters is what you paid for the property, the depreciation you took while you held that property, and what you sold the property for. Your basis for tax purposes is determined by subtracting from what you paid for the property the depreciation you took.

People in the accounting profession tell me there is tremendous under reporting of what is the true basis in a property and real estate.

That the same is true for purposes of capital gains. Obviously, there you do not have the depreciation issue but you have what you paid for stock initially versus what you sold it for. And that there is an appropriate reporting there.

The third area is those who are self-employed who are simply under reporting their income.

The fourth area, and the accounting profession has told me repeatedly, is this offshore business. That this is huge and growing and extremely abusive. That companies simply moving this income offshore, where there is no transparency, no ability for serious oversight, and this is a real hemorrhage of both wealthy individuals and a certain sector of corporate America. A minority, but significant in dollar terms.

Those are areas that people who are in the accounting profession, talking off the record to me, have said they think are the biggest areas of abuse.

Any response to any of that? Any sense from your own experience or own contacts? Mr. Satagaj?

Mr. SATAGAJ. Just on one point, and we all have anecdotal information, and that is part of the problem. Particularly with the sole proprietors, I go back to one of the very first questions I raised. We do not know how many sole proprietors do business primarily with consumers versus other businesses. And so my guess is that it is a consumer-to-business transaction that is most likely not to be reported as income.

You can hear your accountant friends say that and I do tax law, I know what you are talking about, too. But we do not know in any way that we can make a systematic decision OK, this is what we need to do about it. Because you are going to deal with that under reporting far differently than someone who is getting their income from business.

You can go to these areas, but the truth is we are really missing some basic information here.

Chairman CONRAD. That is a point very well taken. If there is one thing that is very frustrating, first of all, we are dealing with a study that tries to indicate the size of the tax gap in 2001. And it is based off returns from the 1980's, updated through a series of attempts to make it relevant to today.

Truthfully, I believe that I think the tax gap is far in excess of the Revenue Service estimate, now that I understand how the Revenue Service made that estimate. I sat down with representatives and went through in some detail how they arrived at this number. I think, if anything, it just jumps out at me that it probably significantly understates how big it is.

We have come to the end here. I want to thank all of the witnesses for participating in this panel. It is certainly beneficial to this committee, as we wrestle with these issues and try to address the longer-term fiscal imbalances that our country faces, which according to the first two witnesses we had before this committee—the head of the General Accounting Office and now most recently last week, the Chairman of the Federal Reserve—they alerted us to the very serious nature of these long-term fiscal imbalances and the adverse effect it could have on our country of a failure to act.

We thank you very much for your constructive suggestions here today.

With that, we adjourn the meeting.

[Whereupon, at 11:45 a.m., the hearing was concluded.]

GAO RESPONSES TO QUESTIONS FOR THE
RECORD ON THE JANUARY 23, 2007 TAX GAP TESTIMONY

QUESTIONS FROM SENATOR LAUTENBERG

Question 1: We know that the Enforcement Division at the IRS generates four dollars in revenue for every one dollar that it spends. Is there a point where extra funding for this division would not pay for itself?

Answer: Conceptually, a tipping point would exist where extra funding for enforcement would not pay for itself. However, the Internal Revenue Service (IRS) does not know where that point is and the tipping point could vary depending on where additional resources are used. Expanding some types of enforcement might result in enforcement costs exceeding enforcement revenue more rapidly than others. IRS does not have reliable data on the marginal returns of investing more resources in various enforcement activities and this further complicates analyses of possible tipping points.

Question 2: According to the IRS 2001 Tax Gap Study, the underreporting of business income was one of the single largest causes for the tax gap and made up to 31 percent or $109 billion of the total tax gap. Do you think that the reduction of Tax Payment assistance centers has been problematic with respect to the tax gap?

Answer: We are not aware of any data that demonstrates the effect that taxpayer service centers have on the tax gap. It is widely accepted that taxpayer service does help increase compliance, particularly among those who wish to comply. However, since a relatively small portion of all taxpayers use taxpayer service centers, any reduction in service from the centers is likely to have a relatively small effect on the overall tax gap.

Question 3: Considering the recommendations in your report and also the Department of the Treasury's Tax Gap Reduction Strategy, do you think that the President's 2007 budget request for the Enforcement division was sufficient?

Answer: Although we have testified that IRS identifies millions of cases of apparent tax noncompliance that it cannot pursue now but could pursue if it had more enforcement resources, determining whether and how much to expand IRS funding is a policy choice for Congress to make. As our January 23, 2007, testimony stated, determining the appropriate level of enforcement resources requires taking into account many factors, such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities.

GAO RESPONSES TO QUESTIONS FOR THE RECORD ON THE JANUARY 23, 2007 TAX GAP TESTIMONY

QUESTION FROM SENATOR SANDERS

Question 1: In February 2004, GAO found that Department of Defense contractors owed about $3 billion in unpaid taxes as of September 30, 2002, because DOD had failed to implement IRS collections procedures. In addition, GAO often "found abusive or potentially criminal activity relating to the federal tax system" through a GAO audit of 47 DOD contractors. To your knowledge, has the Department of Defense or the IRS done anything to collect these unpaid taxes?

Answer: In our report on Department of Defense (DOD) contractors with tax debt—GAO-04-95, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, February 2004,—we reported that DOD was not assisting IRS in collecting tax debt from its contractors because the Defense Finance and Accounting Service (DFAS) had not made most of its payments to contractors available to the Department of the Treasury's Financial Management Service's (FMS) Federal Payment Levy Program (FPLP). IRS and FMS use the FPLP to withhold a portion of the payments going to federal contractors (and other recipients of federal payments) with tax debt as a method of collecting the taxes they owe. We also reported that even if DOD were participating in the FPLP, many of DFAS's payments would not be levied because the tax identification numbers (TINs) in DFAS's systems had not been validated and many did not match IRS's records. This matching is crucial to the government's ability to levy such payments.

In response to recommendations contained in our report, DOD has worked with FMS to develop procedures for more thorough participation in the FPLP. For example, DOD began submitting payments made by all but two of its payment systems to FMS for levy through the FPLP. According to the Federal Contractor Tax Compliance Task Force (established as a result of GAO's work in this area), the two systems not in the FPLP account for less than one percent of DFAS's payments to DOD contractors.

DOD, FMS and IRS have also taken additional actions to improve the collection of tax debt owed by federal contractors. Specifically,

- In 2006, DOD began informing FMS and IRS of the contracts it enters into with contractors, which allows IRS to begin preliminary tax collection procedures that are necessary prior to IRS placing tax debtors into the FPLP. This early notification allows DOD and IRS to begin levying contractor payments earlier than had been possible in the past;

GAO RESPONSES TO QUESTIONS FOR THE
RECORD ON THE JANUARY 23, 2007 TAX GAP TESTIMONY

- DOD has begun a process to validate the TINs in the government's Central Contractor Registration (CCR) to ensure that they are valid and match the TINs in IRS's records; and
- DOD, FMS, and IRS have implemented a provision of the American Jobs Creation Act of 2004 (26 U.S.C. § 6331 (h)(d)) that allows for the levy on payments to federal contractors to be up to 100 percent of the payment amount. Prior to this, the maximum amount that could be levied was limited to 15 percent of each payment.[1]

As a result of these efforts and other improvements in IRS's FPLP-related tax collection policies and procedures, tax collections from FPLP levies on payments to DOD contractors has risen from less than $1 million in fiscal year 2003 to over $26 million in fiscal year 2006. Cumulatively, between fiscal years 2003 and 2006, IRS has collected over $52 million in tax debt from DOD contractors through the FPLP.

In our report, we also discussed 47 contractors whom DOD had paid significant sums—in some instances, several million dollars—at the time they also had significant tax debt. Our investigation of those 47 cases found abusive or potentially criminal activity relating to the Federal tax system. Further, 23 of the 47 cases were included in the FPLP as of December 31, 2005--the last date on which we have updated information. As of then, the status of the 47 cases was:

- in 3 cases, IRS had collected all of the outstanding tax debt;
- in 4 cases, the contractor had agreed to pay the tax debt through installment payments;
- In 27 cases, IRS was no longer attempting to collect the debt because IRS records indicated that the contractors were either bankrupt, out of business, or IRS had determined that they were unable to pay the tax debt. Limited additional follow up on our part indicated that some of these companies continued to operate, but they were doing so under different names and TINs;
- in 4 cases, IRS had initiated criminal investigations based on our referral; and
- in the remaining 9 cases, IRS records indicated it was pursuing collection of the tax debt through its various routine collection activities.

(450565)

[1]This provision has been implemented only for DOD contractors. Implementation for non-DOD contractors is awaiting a technical change in the law to accommodate limitations in FMS's payment systems that do not exist within DFAS's systems.

THE CBO BUDGET AND ECONOMIC OUTLOOK

THURSDAY, JANUARY 25, 2007

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, Nelson, Cardin, Whitehouse, Gregg, and Allard.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. The Committee will come to order.

I want to welcome everyone to the hearing today on the Congressional Budget Office's January budget and economic outlook.

I want to particularly welcome our new Director of the Congressional Budget Office, Dr. Peter Orszag. I notice that Dr. Orszag has with him a special assistant. Maybe Dr. Orszag, you could introduce your daughter, who is with you.

Mr. ORSZAG. Yes, my 6-year-old daughter, Layla, is sitting right behind me. And she's very good at math. So if I need some help she might step up here.

Chairman CONRAD. We will look forward to that.

We are delighted that Dr. Orszag has taken this position. Dr. Orszag is a distinguished economist, one of the most prolific writers in the economic field. He has dealt with almost all of the major issues that are facing us as significant challenges in the years ahead.

I am also especially pleased to note that he was a successful businessman and brings those skills to the job, as well.

We also want to recognize Dr. Marron, who is the Acting Director. We are especially pleased that we understand that you will be staying and we are delighted by that. We thank you for your service, as well.

We have this hearing to review CBO's outlook.

Senator GREGG. All three of us went to the same high school.

Chairman CONRAD. Oh, we did? I deny it.

[Laughter.]

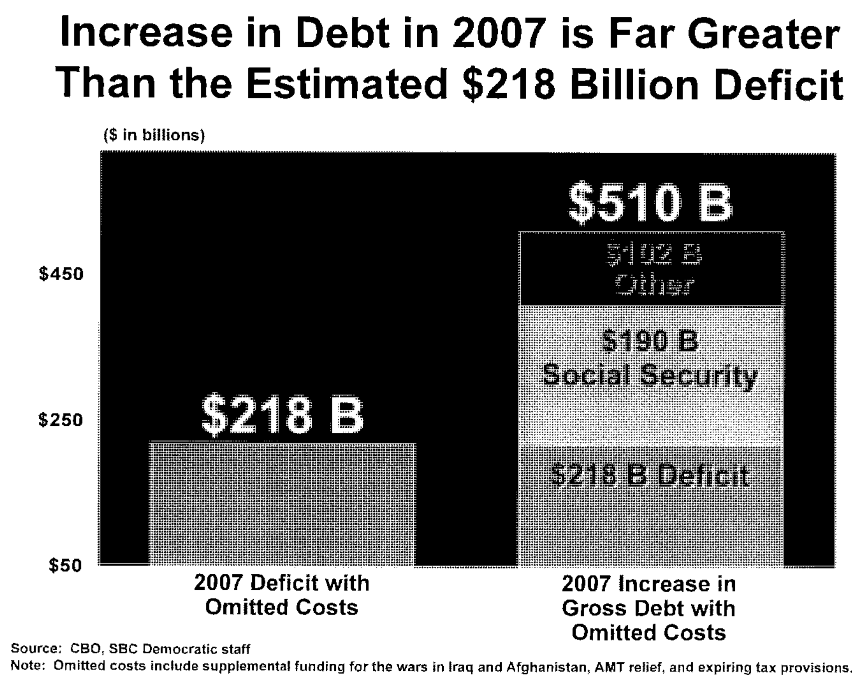
Chairman CONRAD. I have had a chance now to review CBO's report, which was released yesterday. I think it is very important for us to say there is nothing in this report which alters the fact that our Nation's long-term fiscal condition is completely unsustainable.

It is important to remember that CBO is required to assume a continuation of current law and is not allowed to add in the cost of likely policy changes. So this is no criticism of CBO. They are constrained by the requirements under which they operate.

Looking just at 2007, CBO's deficit estimate understates the shortfall because it does not account for the $100 billion war supplemental President Bush is expected to send to us. Nor does it account for the cost of fixing the Alternative Minimum Tax.

Again, this is not any fault of CBO's. This is the way they are required to do things. They are required to base their assessments on current law without respect to policy changes that might occur.

Let me put up the first slide and we will try to go through this quickly. While CBO estimates with omitted costs that the deficit will fall to $218 billion, that number tells only half of the story. Let me indicate that $218 billion is not their estimate. Their estimate is $172 billion. But when we add back what we see as omitted items, the President's war supplemental that has not come up here, the need to fix Alternative Minimum Tax, we come to a deficit of $218 billion. But that significantly understates the red ink, because the debt will increase by $510 billion during this year.



The 10-year baseline projection by CBO understates actual deficits because CBO, as I have said, has to assume continuation of current law. We get a more realistic picture when we put back adjustments for the following items: we add in the cost of the President's proposal to make the tax cuts permanent. That is a cost over 10 years of $2.3 trillion. We add in the cost of Alternative Minimum Tax reform. That is a cost over 10 years of over $1 trillion. We add in the cost of the President's proposed defense buildup, and that is a cost of well over $800 billion. No, the defense buildup is somewhere around $260 billion. The ongoing war cost is over $860 billion. We add in the associated cost of debt service on all of the above items and that is approaching $900 billion.

CBO's Ten-Year Baseline Estimate Understates Deficit

Adjustments:

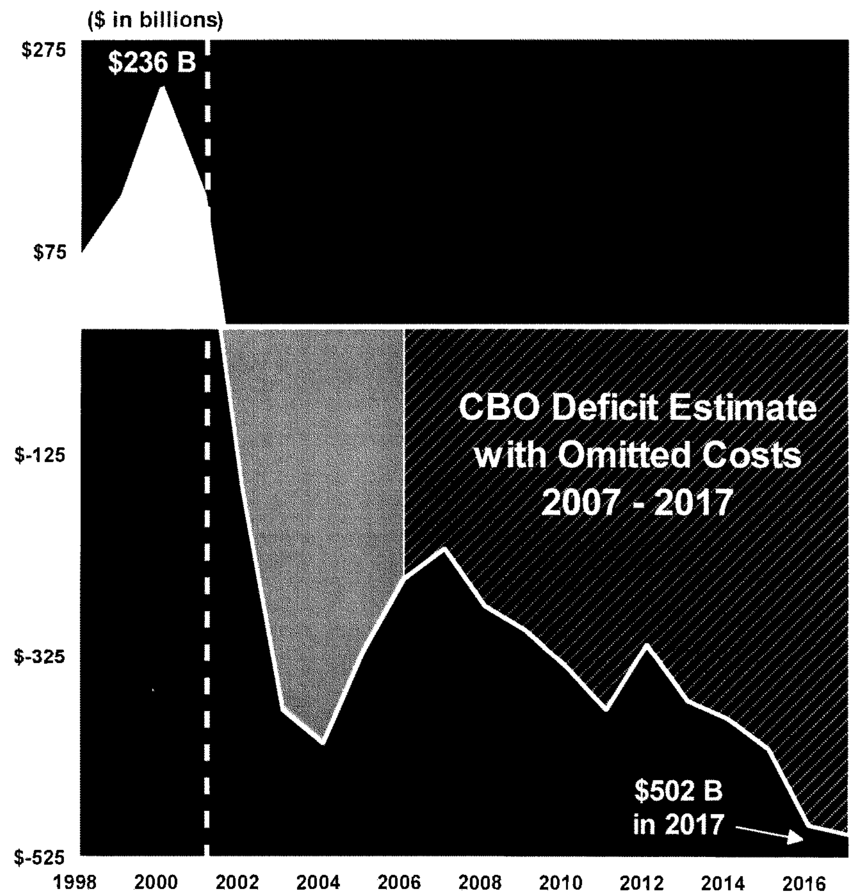
• Cost of Making Tax Cuts Permanent	$2.34 T
• AMT Reform	$1.04 T
• Bush Defense Buildup	$267 B
• Funding for Ongoing War Costs	$857 B
• Debt Service	$986 B
• Remove Extension of 2007 Supplementals	-$920 B
Total	$4.6 T

Source: CBO and SBC Democratic staff
Note: Remove extension of 2007 supplementals includes debt service

We remove the multiyear cost of extending the 2007 emergency funding and get a total adjustment of $4.6 trillion over the next 10 years. The $4.6 trillion is not to the good side, it is the red ink side.

Once we have made these adjustments to CBO's baseline estimate, this is the picture we get of our long-term budget outlook. It shows that significant deficits continue throughout the next 10 years at a time we should be paying down debt to prepare for the coming retirement of the baby boom generation.

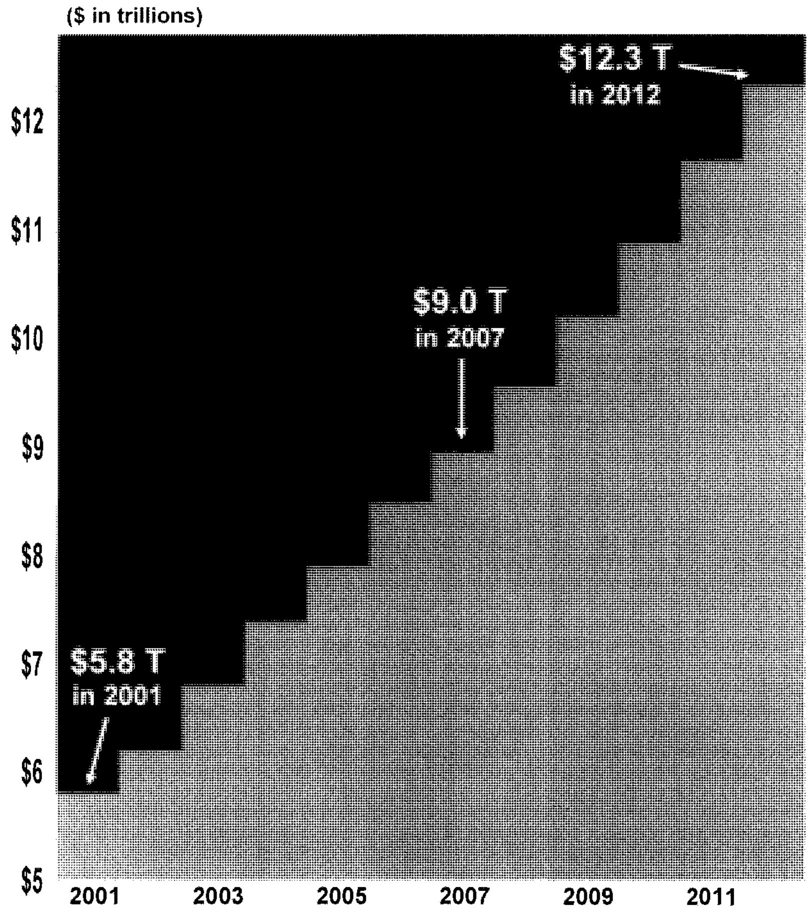
Long-Term Budget Outlook



Source: CBO and SBC Democratic staff
Note: CBO January 2007 estimate with tax cuts made permanent, AMT reform, ongoing war costs, Bush defense buildup, and without extension of 2007 emergency funding.

The reality is that we are facing a wall of debt. At the end of 2001, the year the President took office, gross debt was $5.8 trillion. Under CBO's adjusted baseline, we can see the gross debt will reach $9 trillion by the end of 2007. And if we continue with these policies, gross debt is projected now to soar to over $12 trillion by the end of 2012. I want to emphasize, that is not CBO's estimate. That is our estimate, taking the CBO number and adjusting it for these omitted costs.

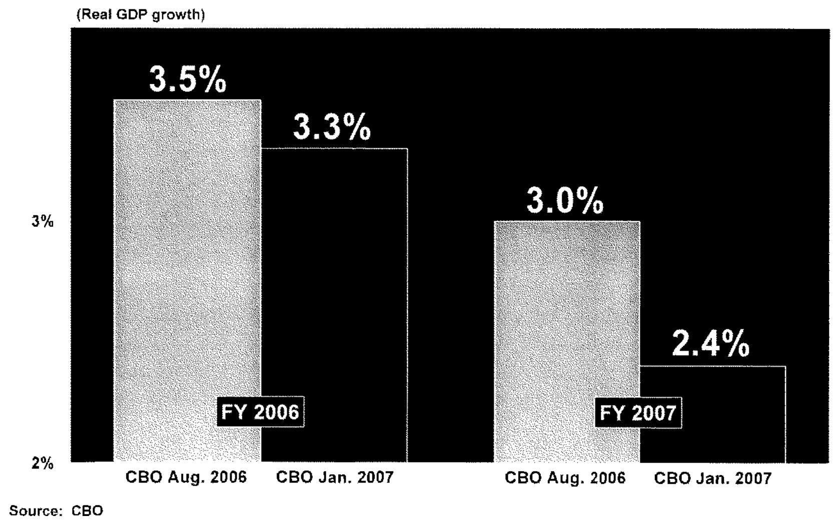
Building a Wall of Debt
Gross Federal Debt Soars



Source: OMB, CBO and SBC Democratic staff
Note: CBO January 2007 estimate with tax cuts made permanent, AMT reform, ongoing war costs, Bush defense buildup, and without extension of 2007 emergency funding.

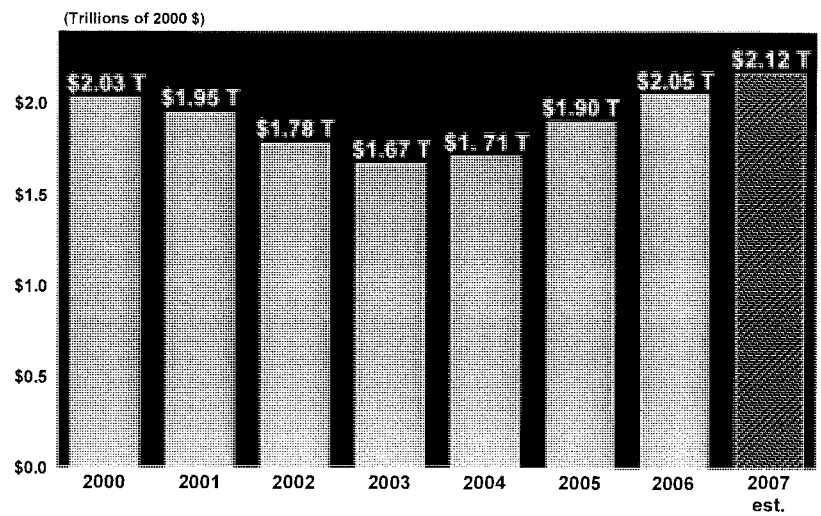
The revenue improvement in CBO's report results from adjustments in CBO's calculations that have nothing to do with stronger economic growth. In fact, CBO's latest figures for economic growth in 2006 and 2007 are actually weaker than the Agency predicted last August. Let me indicate, for 2006 the forecast for economic growth was reduced from 3.5 percent to 3.3 percent. And looking ahead to this year the previous forecast, which estimated economic growth would be about 3 percent, now says economic growth will be 2.4 percent.

Economic Growth for 2006 and 2007 Weaker than in CBO's August 2006 Update



The revenue improvement that we see in this forecast must be considered in the context of the serious collapse in revenue that occurred after 2000. Real revenues, that is adjusted for inflation, only recently exceeded their 2000 level. I know my colleague will want to talk about the last 3 years where we have had significant revenue growth, but that is after we saw significant revenue declines. We saw in 2000 we had revenue of just over $2 trillion. We only got back to that amount in real terms in 2006. So we have had revenue stagnation for six or 7 years and now the estimate for this year is good growth.

Real Revenues Only Recently Exceeded 2000 Level

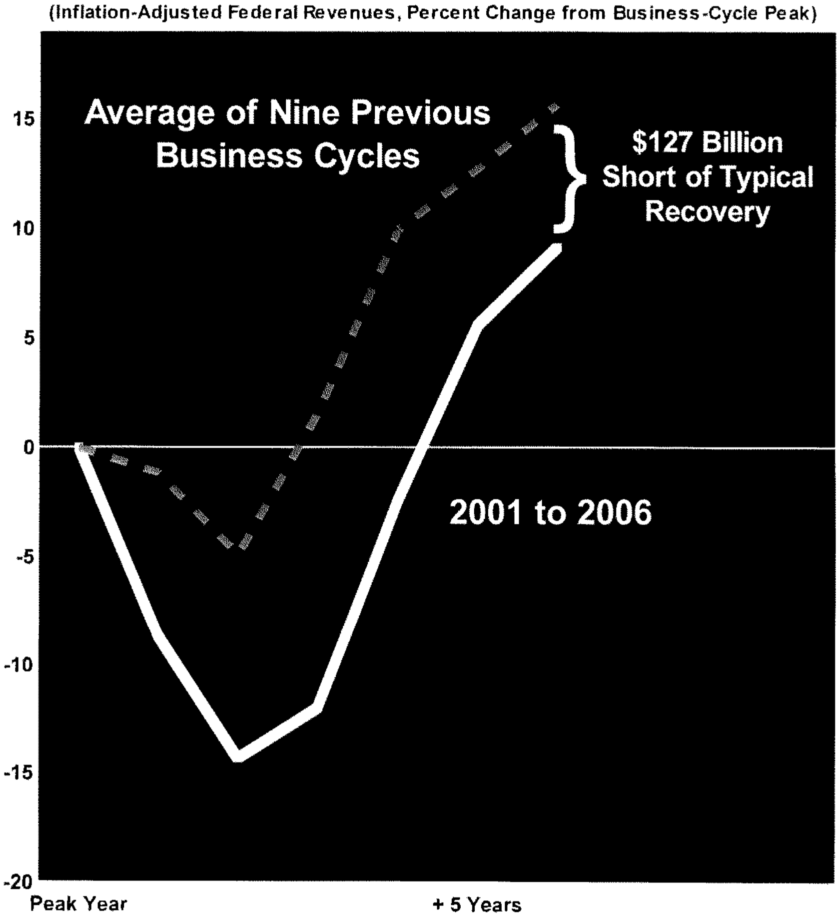


Source: OMB, CBO

Unfortunately, when we compare this revenue growth to previous recoveries, we still see that this is lagging well behind the revenue growth we have seen in previous recoveries. In fact, if we look at the average of the nine previous business cycles, look at all of the recoveries since World War II and compare revenue growth to teach of those other recoveries this recovery is running $127 billion short of the typical recovery.

Real Revenues Lag Typical Recovery Even with Recent Revenue Gains

(Inflation-Adjusted Federal Revenues, Percent Change from Business-Cycle Peak)



Source: CBO, OMB

In his recent testimony before the Senate Budget Committee the head of the GAO, Mr. Walker, summed up our fiscal outlook as follows: "We are an imprudent and unsustainable long-term fiscal path, and while the short-term deficits have improved in recent years, the long-term is getting worse every second of every minute of every day and the time for action is now."

GAO Comptroller General Walker on Solving Nation's Fiscal Problems

"We are on an imprudent and unsustainable long-term fiscal path, and while the short-term deficits have improved in recent years, the long term is getting worse every second of every minute of every day and the time for action is now."

– Government Accountability Office
Comptroller General David Walker
Testimony before Senate Budget Committee
January 11, 2007

Comptroller General Walker has it exactly right. And I am pleased to say on that issue Senator Gregg and I are in agreement. Our long-term situation is unsustainable. We need to respond to it and we need to do it as quickly as we can.

With that, I welcome Senator Gregg.

OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Thank you.

Doctor, it is nice to have you. It is especially nice to have your daughter here, future Exeter student probably.

Let me pick up where Senator Conrad left off, which is the issue of the long-term. Because essentially what the CBO projections say, and although I do not agree with all of the comments made by the Senator from North Dakota, the Chairman, he is correct that there is a lot that is left out because of the rules that you have to function under, such as the war costs and the AMT issue.

But following the mechanics of the CBO baseline, basically if we put things on automatic pilot we would end up in surplus in 2012. But the statutory baseline obviously leaves things off the table that Congress is likely to be put back in, so the baseline surplus number in 2012 would end up being different. Even though a possible surplus looks like that is good news, obviously very good news, it does not address that truly acute issue which we confront, which is the fact that once the baby boom generation begins to retire, all of the numbers go south on us in a very aggressive way.

And in your own estimates you are projecting that there is going to be an approximately 6 percent average annual growth in entitlements over the next 10 years, and that by the year 2017, entitlements will absorb close to 11 percent of the GDP. And as we move out into the years, that number goes up dramatically and becomes unsustainable.

I think it is important, to note that these short-term deficit projections, which are improved, are a function primarily of revenue growth. If you look at what percentage of GDP is the Federal Government generating in revenues, historically we get 18.2 percent of GDP. Today we are getting about 18.4 percent of GDP. So our revenues are robust and they are getting stronger. And CBO's projections are for fairly strong revenue growth as we go forward. And as a result, the Government is moving in a very positive direction for the next few years from a standpoint of the deficit.

But that does not resolve the problem in the out years because you cannot tax your way out of this problem. You cannot grow your way out of this problem. The only way that you are going to address this problem is if you look at the programs which are in place and try to make them affordable for our children at the same time as we allow them to continue to be strong programs for those who are retired.

So I would be interested in your thoughts on that, and I do think it is important that we highlight that and that would not allow the short-term good news, which is very positive, to cause us to take our eye off the real issue which is the long-term seriousness of the problem.

So we appreciate you coming here today. We appreciate your willingness to take on this job.

I also want to join the Chairman in thanking Donald Marron for his wonderful service, extraordinarily good service, and the fact that he is willing to stay on and participate at CBO is critical.

You are our umpire, our fair arbiter, and we appreciate the fact that you have been willing to take on this job, and to have your expertise at the table is going to be a big assistance to us.

Thank you.

Chairman CONRAD. Thank you, Senator Gregg.

Dr. Orszag, please proceed with your testimony.

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

Mr. ORSZAG. Thank you very much, Mr. Chairman. Mr. Chairman and Senator Gregg, I want to first note that I very much look forward to working with you and the rest of the committee and the rest of the Congress as I assume this new position.

I also want to just emphasize how delighted I am to be coming into a position that has such an outstanding staff and that allowed me to get briefed and ready for this testimony in a short period of time.

I want to make five points about the document that we released yesterday, and I think it is important in interpreting the economic and budget outlook to take all five points into account. So with that caveat in mind, the first point is the path of the budget under the baseline.

As you both know very well, that baseline has a particular set of rules associated with it which I will return to in a moment. But under that path, the budget deficit does fall from $248 billion in 2006 to $172 billion this year and then falls further in 2008 to under $100 billion. It then increases slightly in 2009 and 2010. It essentially reaches balance in 2011 as various revenue provisions expire as scheduled under current law, and then moves into surplus in 2012 and thereafter, again under the assumptions of the baseline. Under that baseline, publicly held debt would fall from 37 percent of the economy to 20 percent by the end of the 10-year period.

The second point though is that, as is now well known, that official baseline reflects a particular concept, which is the application of current law with regard to both revenues and spending. It therefore leaves out various things that outside observers believe will occur in terms of change policy that will affect budgetary outcomes.

Mr. Conrad, as you have already mentioned, what we did was we provided a variety of alternative policy paths, changes in policies, that would allow members of this committee and others to evaluate the impact on the budgetary outcomes. I provide just one example of those changes in policies.

The baseline, as you know, assumes that discretionary spending only keeps pace with inflation and not with population growth or with overall economic growth. As a result, discretionary spending falls from 7.8 percent of the economy to 5.8 percent of the economy. If instead, and excluding the spending on the global war on terrorism, discretionary spending kept pace with overall economic growth, the budget balance in 2012 would deteriorate by $122 billion and over the 10-year period by $1.5 billion. Those are inclusive of debt service costs associated with the change in policy.

Furthermore, the official baseline assumes that all of the tax provisions that are scheduled to expire, most of which in 2010, actually do expire. If instead the 2001 and 2003 tax legislation were continued past 2010, the deficit in 2012 would be $267 billion lower and the 10-year impact is $2.3 trillion.

Furthermore, the baseline assumes that the Alternative Minimum Tax will rise from affecting 4 million taxpayers in 2006 to 33 million by 2010. The combination of the assumptions with regard to current law on the EGTRRA and JGTRRA, that is the 2001 and 2003 tax provisions, and with regard to the Alternative Minimum Tax provide the primary explanation for why revenue increases from 18.6 percent of the economy this year to roughly 20 percent in 2011 and thereafter.

If you prevented the Alternative Minimum Tax from growing in the way that is suggested under the baseline, again the deficit impact in 2012 would be roughly $50 billion and the 10-year impact would be over $700 billion. The Alternative Minimum Tax and the 2001 and 2003 tax provisions interact, and taking those interactions into account would add another $61 billion in 2012 and $542 billion over 10 years.

Put that together and instead of a surplus of $800 billion, under this change in policy there would be a deficit of over $4 trillion over the 10-year window.

Obviously, policymakers can evaluate different courses of future policy and evaluate the impact on the budget outcomes under those changes.

My third point is that there is significant uncertainty that surrounds budgetary projections because of future economic developments and other technical changes. Just to put that in context, this year spending will be about $2.7 trillion, revenue we project at $2.5 trillion. That means that if you are 5 percent too high on spending and 5 percent too low on your revenue projection, you shift from a projected deficit of $200 billion to an actual surplus of more than $50 billion. I think it is important for everyone to realize, because the deficit is the difference between two large numbers; being slightly off on those two large numbers can have a very big impact on the difference between the two, the deficit.

So we try to characterize or present for you the implications of that uncertainty. Under our baseline, in 2010 we show a deficit of roughly 1 percent of GDP, 0.9 percent of GDP. But based on past experience, there is a 20 percent probability the deficit may be 3 percent of GDP or larger under current law and there is a 5 percent probability that the budget would actually be in surplus of 3 percent of the economy or more.

So we are trying to provide some insight into the span of the uncertainty that surrounds future budgetary outcomes.

The fourth point is that, consistent with the emergence of projected surpluses under the baseline, there has been a significant shift in the budget baseline since last August. I would emphasize immediately though, and Senator Conrad you already pointed to this, this is not the result primarily of changes in economic assumptions. Those changes in economic assumptions have a very modest effect on the 10-year numbers.

Nor are the 10-year numbers primarily due to changes on the revenue side. In fact on the revenue side, from all the various components, the overall impact is only a little bit more than $50 billion over the 10-year window. There is a more significant impact in the short term and then that diminishes over the long-term. For the 10-year period as a whole, most of what is happening is on the outlay side.

There are two parts. One part is purely artificial. It reflects for how we account for, under current law, discretionary spending. As you know, we take enacted appropriations in the current year and inflate them out over the rest of the projection window in the baseline. Last August, when we were doing the projections, the enacted appropriations included $120 billion for Iraq, Afghanistan, and the global war on terrorism and $56 billion for domestic relief activities, for example with regard to Hurricane Katrina.

This year thus far the Congress has appropriated $70 billion for operating if Iraq and Afghanistan and there is no corresponding appropriation for domestic relief activities. As a result, our baseline now is reduced by $497 billion on defense spending and $500 billion on non-defense spending. In other words, roughly half of the improvement in the 10-year numbers is purely a mechanical implication of how we account for supplemental and unusual spending and does not reflect anything about the underlying fiscal environment.

Another component of it though does reflect changes on the outlay side with regard in particular to Medicare and Medicaid. There have been some real changes in projections of those programs. There has been an improvement over the 10-year window of roughly $445 billion in Medicare spending, the majority of which is in Part D. Part D spending we now project for that 10-year window to be $265 billion lower than in August. That reflects both the actual information we now have on enrollee behavior and patterns and the fact that bids for this year are coming in 15 percent lower than last year, and also that we now expect that larger share of beneficiaries will have other coverage and not take up the Part D benefit. I would be happy to talk further about those changes during the question and answer period.

But, I would emphasize that nothing in those changes alters the fundamental conclusion that over the long term Medicare and Medicaid will continue to grow more rapidly than the overall economy and will put severe pressure on the overall fiscal picture.

That brings me to my final and perhaps most important point. The long-term picture facing the Federal Government is not pretty. Under current law, without addressing in particular ongoing cost increases in our health programs, we face a very serious fiscal imbalance. I would agree with both Chairman Bernanke and Mr. Walker that it is better to address that sooner rather than later because it opens up more options for how to address the problem.

Even within the budget window you can start to see the pressure that is building. Medicare and Medicaid, the Federal share of Medicaid, amount to 4.5 percent of the economy today. By 2017, the end of our projection window, we project that they will amount to 5.9 percent of our economy. If health care costs continue to grow at the same rate as they have over the past 40 years, which is the top line in this chart, by 2050 those two programs alone would account for 20 percent of the economy, which is basically the size of the entire Federal Government today.

Even if health care cost growth slowed so that it is only 1 percentage point faster than economic growth, those two programs would account for 10 percent of the economy. That is the fundamental long-term problem facing the Federal Government, and it is related to a problem facing the private sector also, which is cost growth in the health sector.

I look forward to working with you to provide you with the analytical input so that you can start to address that fundamental problem in the long-term fiscal picture for the United States.

So just to very briefly summarize, there is some short-term good news in this report. But the good news is not quite as good as it might initially seem. And the long-term picture remains very, very serious and deserving of attention.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Orszag follows:]

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

The Budget and Economic Outlook: Fiscal Years 2008 to 2017

before the
Committee on the Budget
United States Senate

January 25, 2007

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

Chairman Conrad, Senator Gregg, and Members of the Committee, thank you for giving me this opportunity to present the Congressional Budget Office's (CBO's) budget and economic outlook for fiscal years 2008 to 2017.[1]

If current laws and policies remained the same, the budget deficit would equal roughly 1 percent of gross domestic product (GDP) each fiscal year from 2007 to 2010, the Congressional Budget Office (CBO) projects. Those deficits would be smaller than last year's budgetary shortfall, which equaled 1.9 percent of GDP (see Table 1). Under the assumptions that govern CBO's baseline projections, the budget would essentially be balanced in 2011 and then would show surpluses of about 1 percent of GDP each year through 2017 (the end of the current 10-year projection period).

The favorable outlook suggested by those 10-year projections, however, does not indicate a substantial change in the nation's long-term budgetary challenges. The aging of the population and continuing increases in health care costs are expected to put considerable pressure on the budget in coming decades. Economic growth alone is unlikely to be sufficient to alleviate that pressure as Medicare, Medicaid, and (to a lesser extent) Social Security require ever greater resources under current law. Either a substantial reduction in the growth of spending, a significant increase in tax revenues relative to the size of the economy, or some combination of spending and revenue changes will be necessary to promote the nation's long-term fiscal stability.[2]

1. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

2. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005), *Updated Long-Term Projections for Social Security* (March 2005), and *The Outlook for Social Security* (June 2004).

CBO's baseline budget projections for the next 10 years, moreover, are not a forecast of future outcomes; rather, they are a benchmark that lawmakers and others can use to assess the potential impact of future policy decisions. The deficits and surpluses in the current baseline are predicated on two key projections (which stem from longstanding procedures that were, until recently, specified in law).[3]

- Revenues are projected to rise from 18.6 percent of GDP this year to almost 20 percent of GDP in 2012 and then remain near that historically high level through 2017. Much of that increase results from two aspects of current law that have been subject to recent policy changes: the growing impact of the alternative minimum tax (AMT) and, even more significantly, various provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and modified by subsequent legislation, which are scheduled to expire by December 31, 2010.

- Outlays for discretionary programs (activities whose spending levels are set anew each year through appropriation acts) are projected to decline from 7.8 percent of GDP last year to 5.8 percent of GDP by 2017—a lower percentage than any recorded in the past 45 years. That projection derives mainly from the assumption in the baseline that discretionary funding will grow at the rate of inflation, which is lower than the growth rate that CBO projects for nominal GDP. The projection for discretionary spending

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

Table 1.

CBO's Baseline Budget Outlook

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2012	Total, 2008-2017
							In Billions of Dollars							
Total Revenues	2,407	2,542	2,720	2,809	2,901	3,167	3,404	3,550	3,717	3,896	4,084	4,284	15,001	34,531
Total Outlays	2,654	2,714	2,818	2,926	3,038	3,179	3,234	3,391	3,533	3,687	3,892	4,034	15,194	33,731
Total Deficit (-) or Surplus	**-248**	**-172**	**-98**	**-116**	**-137**	**-12**	**170**	**159**	**185**	**208**	**192**	**249**	**-194**	**800**
On-budget	-434	-357	-299	-332	-367	-258	-85	-101	-79	-57	-72	-10	-1,342	-1,662
Off-budget[a]	186	185	201	216	230	246	255	261	264	265	264	259	1,148	2,461
Debt Held by the Public at the End of the Year	4,829	4,995	5,104	5,232	5,380	5,403	5,242	5,089	4,912	4,709	4,521	4,274	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	18.4	18.6	19.0	18.7	18.4	19.2	19.8	19.8	19.8	19.9	20.0	20.1	19.1	19.5
Total Outlays	20.3	19.9	19.7	19.5	19.3	19.3	18.8	18.9	18.8	18.8	19.1	18.9	19.3	19.1
Total Deficit (-) or Surplus	**-1.9**	**-1.3**	**-0.7**	**-0.8**	**-0.9**	**-0.1**	**1.0**	**0.9**	**1.0**	**1.1**	**0.9**	**1.2**	**-0.2**	**0.5**
Debt Held by the Public at the End of the Year	37.0	36.6	35.7	34.8	34.2	32.8	30.5	28.3	26.2	24.0	22.1	20.1	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	13,066	13,645	14,300	15,014	15,742	16,465	17,205	17,973	18,764	19,582	20,425	21,295	78,726	176,766

Source: Congressional Budget Office.

Note: n.a. = not applicable.

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

implicitly assumes that no additional funding is provided for the war in Iraq in 2007 and that future appropriations for activities related to the war on terrorism remain equivalent, in real (inflation-adjusted) terms, to the $70 billion appropriated so far this year.

Policy choices that differed from the assumptions in the baseline would produce different budgetary outcomes. For example, if lawmakers continued to provide relief from the AMT (as they have done on a short-term basis for the past several years) and if the provisions of EGTRRA and JGTRRA that are scheduled to expire were instead extended, total revenues would be almost $3 trillion lower over the next 10 years than CBO now projects. Similarly, if discretionary spending (other than for military operations in Iraq and Afghanistan) grew at the rate of nominal GDP over the next 10 years, total discretionary outlays during that period would be nearly $1.3 trillion higher than in the baseline. Combined, those policy changes—and associated debt-service costs—would produce a deficit of $328 billion (1.9 percent of GDP) in 2012 and a cumulative deficit over the 2008–2017 period of $4.2 trillion (2.4 percent of GDP).

Underlying CBO's baseline projections is a forecast that U.S. economic growth will slow in calendar year 2007 but pick up in 2008. Specifically, CBO anticipates that GDP will grow by 2.3 percent in real terms in 2007, a full percentage point less than the growth recorded last year. For 2008, CBO forecasts that GDP growth will rebound to

3.0 percent. Under the assumptions of the baseline, real GDP growth would continue at a similar rate in 2009 and 2010 and then slow to 2.7 percent in 2011 and 2012. For the rest of the projection period, average growth of real GDP is projected to decrease to 2.5 percent per year as increases in the size of the workforce continue to slow.

The Budget Outlook

CBO estimates that if today's laws and policies did not change, federal spending would total $2.7 trillion in 2007 and revenues would total $2.5 trillion, resulting in a budget deficit of $172 billion. The additional funding that is likely to be needed to finance military operations in Iraq and Afghanistan would put that deficit in the vicinity of $200 billion. Even so, this year's shortfall would be smaller than the 2006 deficit of $248 billion.

Baseline Projections for the 2008–2017 Period

Under current laws and policies, the deficit would drop further in 2008, to $98 billion. That decrease results primarily from two factors. On the revenue side of the budget, receipts from the AMT are estimated to increase by about $60 billion next year because of the scheduled expiration of the relief provided through tax year 2006. (In addition, telephone-tax refunds, which totaled $13 billion in 2007, are projected to drop by $10 billion in 2008.) On the spending side of the budget, outlays for operations in Iraq and Afghanistan and for relief and recovery from hurricane damage are about $14 billion lower in 2008 than in 2007 under the assumptions of the baseline.

The baseline deficit is projected to rise modestly over the following two years, 2009 and 2010, as outlays grow by about 3.8 percent annually and revenues increase by about 3.3 percent a year. That projected growth rate for revenues is lower than in recent years, mainly because corporate profits and capital gains realizations are expected to revert to levels that are more consistent with their historical relationship to GDP.

After 2010, spending related to the aging of the baby-boom generation will begin to raise the growth rate of total outlays. The baby boomers will start becoming eligible for Social Security retirement benefits in 2008, when the first members of that generation turn 62. As a result, the annual growth rate of Social Security spending is expected to increase from about 4.5 percent in 2008 to 6.5 percent by 2017.

In addition, because the cost of health care is likely to continue rising rapidly, spending for Medicare and Medicaid is projected to grow even faster—in the range of 7 percent to 8 percent annually. Total outlays for those two health care programs are projected to more than double by 2017, increasing by 124 percent, while nominal GDP is projected to grow only half as much, by 63 percent (see Figure 1). Consequently, under the assumptions of CBO's baseline, spending for Medicare, Medicaid, and Social Security will together equal nearly 11 percent of GDP in 2017, compared with a little less than 9 percent this year.

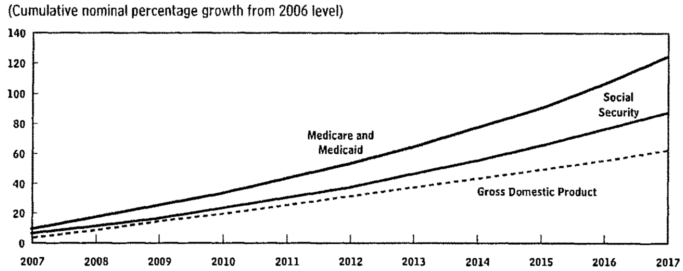
Revenues are projected to increase sharply after 2010 given the assumption that various tax provisions expire as scheduled. In the baseline, total revenues grow by 9.2 percent in 2011 and by 7.5 percent in 2012, thereby bringing the budget into surplus. Beyond 2012, revenues are projected to grow at about the same pace as outlays (by roughly 4.5 percent a year), keeping the budget in the black through 2017 under baseline assumptions.

Relative to the size of the economy, outlays are projected to range between 18.8 percent and 19.7 percent of GDP during the 2008–2017 period under the assumptions of CBO's baseline—lower than the 20.6 percent average of the past 40 years (see Figure 2). Mandatory spending (funding determined by laws other than annual appropriation acts) is projected to grow by 5.9 percent a

Figure 1.

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

(Cumulative nominal percentage growth from 2006 level)



Source: Congressional Budget Office.

year over that period, which is faster than the economy as a whole. By contrast, discretionary appropriations are assumed simply to keep pace with inflation and, to a lesser extent, with the growth of wages. Thus, discretionary outlays are projected to increase by about 2.0 percent a year, on average, or less than half as fast as nominal GDP.

CBO projects that revenues will average 18.7 percent of GDP from 2008 to 2010 (close to the 18.6 percent level expected for this year) before jumping sharply in 2011 and 2012 with the expiration of tax provisions originally enacted in EGTRRA and JGTRRA. After that, revenues are projected to continue growing faster than the overall economy for three reasons: the progressive structure of the tax code combined with increases in total real income, withdrawals of retirement savings as the population ages, and the fact that the AMT is not indexed for inflation. Under the assumptions of the baseline, CBO projects that revenues will equal 20.1 percent of GDP by 2017—a level reached only once since World War II.

Federal government debt that is held by the public (mainly in the form of Treasury securities sold directly in the capital markets) is expected to equal almost 37 percent of GDP at the end of this year. Thereafter, the baseline's projections of smaller annual deficits and emerging surpluses diminish the government's need for additional borrowing, causing debt held by the public to shrink to 20 percent of GDP by 2017.

Changes in the Baseline Budget Outlook Since August

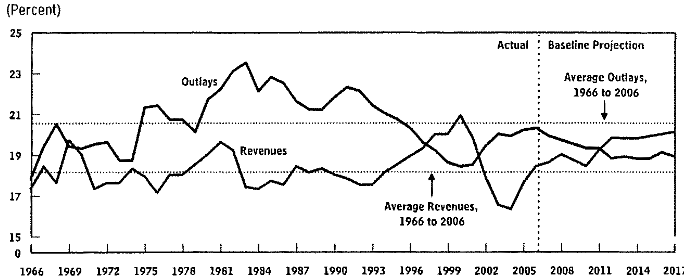
Although the long-term budgetary picture continues to be worrisome, the baseline outlook for the next 10 years has brightened in the five months since CBO issued its previous projections.[4]

4. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2006).

Figure 2.

Total Revenues and Outlays as a Percentage of Gross Domestic Product, 1966 to 2017

(Percent)



Source: Congressional Budget Office.

Budgetary outcomes have improved for each year from 2007 to 2016 (the period covered by the previous projections), from a reduction of $114 billion in the deficit for 2007 to a swing of $285 billion in the bottom line for 2016 (from a deficit of $93 billion to a surplus of $192 billion). In all, those reductions represent a difference of about 1.2 percent of GDP over 10 years.

Those changes overstate the fundamental improvement in the underlying budget outlook, however. Roughly half of the total change stems from the baseline's treatment of previous supplemental appropriations for disaster relief and the irregular pattern of funding for military operations in Iraq and Afghanistan. Consequently, more than half of the improved bottom line is unrelated to changes in the underlying budgetary and economic environment.

Much of the remaining change to the current baseline comes from lower projected spending for Medicare. Total outlays for that program over the 2007–2016 period are nearly 8 percent lower in this baseline than in CBO's August projections. That reduction is largely attributable to new estimates of per capita costs for all Medicare benefits, but it also reflects lower projections of the number of enrollees in the prescription drug benefit program. Those recent changes, however, do not significantly alter the upward trajectory of Medicare spending in the long term.

The Economic Outlook

The Federal Reserve's shift in monetary policy over the past two and a half years and the recent decline in housing construction are expected to restrain economic growth this year, but the economy is likely to post solid gains next year. CBO forecasts that GDP will grow by 2.3 percent in real terms in calendar year 2007 but by 3.0 percent in 2008 (see Table 2).

Gains in employment, which remained solid in 2006 despite a slowdown in economic growth during the second half of the year, are expected to lessen in 2007. That change may cause unemploy-

Table 2.

CBO's Economic Projections for Calendar Years 2007 to 2017

(Percentage change)

	Estimated	Forecast		Projected Annual Average	
	2006	2007	2008	2009-2012	2013-2017
Nominal GDP					
Billions of dollars	13,235	13,805	14,472	17,395 [a]	21,519 [b]
Percentage change	6.3	4.3	4.8	4.7	4.3
Real GDP	3.3	2.3	3.0	2.9	2.5
GDP Price Index	2.9	1.9	1.8	1.8	1.8
PCE Price Index[c]	2.8	1.7	1.9	2.0	2.0
Core PCE Price Index[d]	2.3	2.1	1.9	2.0	2.0
Consumer Price Index[e]	3.4	1.9	2.3	2.2	2.2
Core Consumer Price Index[f]	2.6	2.6	2.3	2.2	2.2
Unemployment Rate (Percent)	4.6	4.7	4.9	5.0	5.0
Interest Rates (Percent)					
Three-month Treasury bills	4.7	4.8	4.5	4.4	4.4
Ten-year Treasury notes	4.8	4.8	5.0	5.2	5.2

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

Notes: GDP = gross domestic product.

Percentage changes are measured from one year to the next.

a. Level in 2012.

b. Level in 2017.

c. The personal consumption expenditure chained price index.

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

e. The consumer price index for all urban consumers.

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

ment to edge up from the 4.6 percent rate recorded for 2006. As housing construction stabilizes, however, economic growth and employment should start to recover by the middle of 2007.

Last year, robust investment by businesses and solid growth in exports helped the U.S. economy absorb the decline in housing construction. Investment and exports are expected to continue to support the economy in 2007. For many years, businesses' capital stock (the plant, equipment, and software they use for production) grew more slowly than overall demand for U.S. goods and services; as a result, despite the recent growth of investment, the nation's capital stock is still low relative to the level of demand. Investment should therefore continue to increase, even if the growth of demand slows. Similarly, export growth is likely to remain strong because increases in demand for U.S. products overseas are durable enough to withstand a slight slowdown in U.S. demand for other countries' exports.

In the absence of any adverse price shocks to the economy, the core rate of inflation—which excludes prices for food and energy—is expected to ease slightly this year. Overall inflation (as measured by the year-to-year change in the price index for personal consumption expenditures) will fall from last year's rate of 2.8 percent to 1.7 percent in 2007 because of a large drop in prices for motor fuels near the end of last year. The core rate of inflation, however, is expected to decline less rapidly during 2007.

CBO anticipates that the interest rate on three-month Treasury bills will drop slightly this year from the 4.9 percent rate seen at the end of 2006. Further declines are expected during 2008, when that rate will average 4.5 percent. CBO's forecast assumes that long-term interest rates will edge up as short-term interest rates decline. The rate on 10-year Treasury notes, for example, is forecast to rise from 4.8 percent this year to 5.0 percent in 2008.

Beyond the two-year horizon, CBO projects that economic growth (as measured by increases in real GDP) will average 2.7 percent a year from 2009 to 2017. As members of the baby-boom generation begin to retire, the growth of the labor force is expected to slow, pushing down the rate of real GDP growth during the second half of that period. Projected rates of inflation, unemployment, and growth of labor productivity average 2.0 percent, 5.0 percent, and 2.2 percent, respectively, after 2008. Interest rates are projected to average 4.4 percent for three-month Treasury bills and 5.2 percent for 10-year Treasury notes.

Chairman CONRAD. Thank you. And thank you for your excellent testimony and the work of you and your staff. I think you have put it in perspective that the short term we have seen some improvement. The long-term really has not changed and it is a daunting picture.

I know Senator Gregg has presented this to his caucus and before this committee. I have presented it to my caucus. It is a hard thing to get people, I guess it is very deep in human nature. It is hard to get people to respond to something that is over the horizon or down the road or off in the future.

Could you tell us when you say we should act sooner rather than later, what would you say if you were addressing our colleagues as to why? Why it is important to act sooner? Our colleagues, in fact, I had a colleague say to me yesterday, Kent, you are talking about a problem that is off in 2018. We have a lot of urgent problems to deal with right now. This is not urgent.

Mr. ORSZAG. I have two responses. The first is the longer we wait, the larger the burden that we are putting on future generations, and I am not going to invoke my daughter but people like my daughter. That raises not just economic questions but other questions as well.

The second reason though is the sooner that we act, the more that we can try things and experiment and see what works and see what does not so that we can evolve in our approach. This underlying problem is not going to be solved with the snap of a finger and just a one-off solution.

So I think it is pretty clear that what we need to be doing is trying different things, and it is obviously up to you to decide what things we should try. But try different things, see what works, and then adapt as we go.

The longer you wait, the less experience you'll have. I was, for example, interested that in the New York Times this morning there is a report on the effort that CMS, the Medicare agency, is experimenting with paying for performance and the early results there. But that is the kind of effort—in the so called Premier Program—the kind of effort that will help give you the information you need to bend those lines. If you just wait, you are acting in a void.

Chairman CONRAD. Let me ask you this question. Last evening I was interviewed on television with a colleague and I was asked what had been the contributing factors to the deficits. And I said well, it is obviously increased spending and tax cuts. The two of those together have exploded the debt.

My colleague said no, the Senator is wrong on the question of tax cuts. She said tax cuts produce revenue. I was really kind of taken aback and I said you know, in my judgment, tax cuts contribute to economic growth but they in no way pay for themselves. That is been the testimony of the head of the Federal Reserve. That has been the testimony of previous CBO directors. That has been the result of the Treasury's own study that shows tax cuts maybe offset 10 percent of their costs. There are other studies that have been done by CBO.

CBO said to us, in their analysis, that tax cuts would stimulate enough economic growth to replace 22 percent of lost revenue in the first 5 years. Those were on optimistic assumptions. On pessimistic assumptions, the growth effects of tax cuts did nothing to offset revenue loss.

So whether it is zero or 10 percent or 22 percent, the studies that we have been presented with say that tax cut simply do not pay for themselves. They slightly offset their additions to the deficit.

I would ask for your review. What would you say is the state of the economic literature on this question of do tax cuts pay for themselves? I would just say, if they do, this is the greatest news we could have because we could have a whole new round of tax cuts and eliminate the deficit.

[Laughter.]

Mr. ORSZAG. Senator, the effect of a tax cut depends in part on what kind of tax cut it is and how it is financed, whether it is financed by a deficit. Many tax cuts can generate some economic growth, some additional economic activity. But the vast bulk, the preponderance of the evidence strongly suggests that that additional economic activity, which generates some additional revenue, offsets only a modest share of the original cost. So whether it is 10 percent or 20 percent or 25 percent, some go even higher than that, the credible evidence I have seen suggests that the offset is only a small share of the original cost.

Chairman CONRAD. To be fair, I should say Gregg Mankiw, who was Chairman of the President's Council of Economic Advisers, said in his analysis where you have capital taxes there you could get as much as a 50 percent offset on capital taxes. On others, on income taxes, he said 17 percent, which would be pretty close to the 22 percent CBO found in the first 5 years under optimistic assumptions.

I thank you for that answer. Senator Gregg?

Let me indicate that we are going to have a vote momentarily, at 10:30. That is unfortunately why you see attendance is not as we would normally have, because they have called a vote for 10:30.

Senator GREGG.

Senator GREGG. Thank you. Thank you, Mr. Chairman.

Picking up on this line of thought relative to the implications of tax policy, the reverse of the case the Chairman is making also probably applies. That is, you can raise taxes to a point where you significantly stagnate economic activity. Would that not be true?

Mr. ORSZAG. Yes, and actually let me quickly add a very important caveat. I was speaking with regard to studies that apply to basically the current structure of the U.S. tax system. As you move up to higher and higher marginal tax rates, that conclusion could be different.

Senator GREGG. Of course, that was Arthur Laffer's studies that showed that.

The issue, I think, is what is the right tax level? Obviously it is not zero and obviously it is not 100 percent. It is somewhere in between. It would seem to me that when you have a tax law which is today producing revenues that exceed the average revenues that we historically haveten in this country, the average being 18.2 percent and we are now getting 18.5 percent, that you have a tax law that is working fairly well.

My real question here, because the issue is closing the gap in the out years between liabilities and revenues relative to entitlement programs, gets to the issue of what size Government can the economy afford and still be efficient, productive and growing? And when does the Government become so large that it creates an inefficient economy and one which is not as productive and thus, does not create as many jobs?

Historically, we have spent about 20 percent of the Gross National Product on the Federal Government and we have taken in about 18.2 percent, so we have run a structural deficit.

But what is the number that you would say the Government can afford—at what size? If we know entitlement spending, if it is allowed to continue at its present pace, Medicare and Medicaid being the primary drivers of this, will exceed potentially 30 percent of Gross National Product by the year 2040, which seems to be a staggering number, and you know you are going to have to rein that back to some number that is manageable, do you have a manageable number? Is it 20 percent? Is it 22 percent? Is it 24 percent?

Mr. ORSZAG. Senator, I think ultimately the level of spending and revenue is up to policymakers like yourself to decide. What I would say about the economic effects is a lot depends not just on the level of revenue as a share of GDP but how you raise that revenue, whether it is through individual income taxes, whether it is through corporate income taxes, whether it is through consumption or value added taxes, can have a significant effect on the economic implications.

The other thing I would say is I do not think that there is a single threshold. I cannot give you a jump off the cliff kind of threshold. A lot of the effects that are associated with revenue changes tend to be gradual and linear so that they just grow bigger as you move up a curve, rather than having a single jumping off kind of point.

Senator GREGG. I do not have time right now, but I would be interested in which one of these—you clearly view taxes not as monolithic but as being divisible into some that produce more productivity and some that produce less. I would be interested in getting your written thoughts on that, if you had a chance.

One question I did want to ask, the House just a little while ago passed what they call the Medicare Prescription Drug Price Negotiation Act, which basically tells CMS to negotiate prices with drug companies relative to Part D premiums, with the representation that is going to save some money somehow.

CBO a year ago gave us a commentary that it would not, for what I think are fairly strong and obvious reasons. I am wondering if that remains CBO's view of that position?

Mr. ORSZAG. Yes, it does, and let me just try to explain both why and also why some of the price comparisons that I have seen with regard to say the prices that the Veterans Administration gets relative to some of the prescription drug plans are not really appropriate to the legislation that was introduced or passed by the House.

The reason that the Veterans Administration can get lower prices than other players is twofold. One is that there is a direct price intervention where the Federal Government, under the Federal Supply Schedule and the Federal Ceiling price, requires a particular set of effectively discounts or best prices to be offered.

The second is that the Veterans Administration then runs a formulary. It includes some drugs on its list and excludes others.

The House legislation does not take either step. And I would note, you can get price reductions through those two steps, but there are broader ramifications from them. So just price negotiation by itself is unlikely to produce any significant cost savings because you do not have either of the tools that the Veterans Administration and some other government programs used to get price reductions.

And if you were to apply those kinds of tools in the Medicare program, there would be other consequences that would need to be weighed very carefully.

Senator GREGG. Specifically rationing. There would be rationing the drugs that would be available to citizens under Part D

Mr. ORSZAG. A formulary does include some drugs and exclude others. That is the definition of a formulary.

Senator GREGG. It is called rationing. Thank you.

Chairman CONRAD. I would like to just go back, if I can, to this question of taxes. And I would say to Senator Gregg, I just asked the staff to get for us the effective tax levels in other countries and their rates of economic growth. If you look at all taxes in the United States, Federal, State and local, we are at 26.4 percent of GDP and our real growth, real GDP growth for the last 10 years has been just under 1 percent.

Interestingly enough, Sweden has had a much higher rate of growth, 2.2 percent and a tax burden almost double ours, 50.2 percent. Denmark has had a higher rate of economic growth than have we over the last 10 years, and they are almost at 50 percent. The United Kingdom has had a much higher rate of economic growth than we have and they have a tax burden 10 points higher, per capita I should say.

It really raises interesting questions about where the breakpoints are.

I must say I was very surprised by these numbers. I thought we would probably have higher rates of economic growth than these countries that have much higher levels of taxation. Any comment that you would want to make?

Mr. ORSZAG. A couple of comments. As you know, the structure of taxation in European countries is different from here with more reliance on value added taxes.

I would also say a lot of the popular discussion of Europe fails to distinguish between the Scandinavian countries, some of them that you just mentioned, and continental countries like France and Germany. The economic experiences do vary fairly significantly between the Scandinavian countries and the continental European countries.

Chairman CONRAD. I am Scandinavian. I am Danish, Swedish and Norwegian.

Mr. ORSZAG. Almost all of them.

Chairman CONRAD. Yes, I am sort of the Scandinavian melting pot.

I look even at Italy. Italy has had higher economic growth, substantially higher. Growth of real GDP per capita in Italy, 2.3 percent versus our 0.9 percent, and yet they have a level of taxation that is almost 43 percent, 50 percent higher than ours.

You raise, I think, a very important question, and that is different types of taxation have different economic effects.

This vote has started so I am going to go and cast my vote. So we will come back. There are other members who have indicated they want a chance to ask questions, as well, and we are waiting for this vote. So we will go do that. We will put the committee in adjournment awaiting the call of the Chair.

[Recess.]

Chairman CONRAD. We will resume the hearing with Senator Whitehouse and his questions.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Welcome and congratulations. I look forward to working with you.

I wanted to followup on a couple of things that I heard, I was not here but I had reported to me that happened in my absence. I had to be in the Judiciary Committee, my apologies.

The first has to do with Medicare Part D and the so-called non-interference clause. During my campaign, this was a very big issue in Rhode Island. There were studies that I cited to during the course of the campaign that showed not only were there substantial savings available if the non-interference clause were repealed and if the Federal Government took the logical next step and began to negotiate and drive prices down, but that the amount of savings would be enough to fill the so-called doughnut hole and provide coverage for folks so that we were not seeing the kind of things that I saw in Rhode Island like the 93-year-old lady who, after 93 years of independence loses her apartment because she cannot afford both her rent and the cost of her pharmaceuticals while she is in the doughnut hole.

I gather that you said that you did not see that there would be any savings from that. I am just wondering if you would explain what the analysis is that gets you to that point? And what your assumption is about what the Federal Government would do in answer to that legislative change that could produce no net savings?

Mr. ORSZAG. Thank you, Senator. I am glad you asked that question.

I want to make it very clear that there are potential savings in a $50 billion program. The question is how those savings could be realized. I did not say and do not believe that there are not price reductions that are possible for pharmaceutical prices under the Medicare Part D program.

The question is what steps are necessary to get those deductions, and there are other consequences.

Senator WHITEHOUSE. Are there steps that would involve the Secretary of the Department of Health and Human Services?

Mr. ORSZAG. Absolutely, but just negotiating authority by itself, without either legislation specifying a direct price intervention, in other words that Medicare Part D plans would be offered, for example, the best price offered in the private market, or without the Secretary having the ability to set a Federal Government formulary, that just negotiating authority by itself is unlikely to give the Secretary any leverage.

One could imagine the Secretary taking other nonprice things into account. Imagine the Secretary taking steps that involve things outside of the price negotiations themselves. But that is difficult to imagine right now and the legislation does not direct the Secretary to do so.

So if the Secretary just walks in and says I am here to negotiate over price, but there is no statutory requirement that you offer the best price that is offered to anyone, and I do not have the authority to set up my own formulary, there is very little leverage. And that is why we do not think that there will be any significant price reduction.

I would note just quickly that giving the Secretary that kind of authority, what I just mentioned, has other consequences. For example, with regard to Medicaid where there is a direct price intervention also, the evidence suggests that pharmaceutical companies raise prices in the rest of the retail market to partially offset the reduction that is offered to Medicaid. In a program as big as Part D, which is now more than a quarter of retail sales, we will need to carefully evaluate the pros and cons of the kinds of steps that would unlock the savings that many people believe are potentially there.

Senator WHITEHOUSE. Thank you. I think my time has expired.

Chairman CONRAD. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I also apologize for not being here earlier. We had a conflicting hearing that I had to attend at that particular point in time.

One of the things that has concerned me is when we look at the baseline we tend to treat expiring taxes differently than expiring programs, making the assumption that the expired program is going to continue in perpetuity. That is not the case of all taxes. Excise taxes, for example, dedicated to a trust fund are assumed to extend out in perpetuity.

But many of those taxes that are set to expire here in 2010 are not assumed to be extended.

Would you share with me what your view is? It seems to me we have an inconsistency here. If you have spending, whether it is on the revenue side or whether it is on the programmatic side, spending is spending. It ought to be really reflective. I would like to hear your comments on that.

Mr. ORSZAG. Senator, as you know, the baseline rules that we apply are long-established historical rules that we continue to apply and there is an inherent logic to them. I would say that there may be a difference between the baseline for projecting likely future outcomes, for example most people predict that at least part of the 2001 and 2003 tax legislation will continue. So in the most likely scenario those tax provisions will continue. That is one question.

A separate question is for budget scoring purposes what baseline should you be measuring changes from? The current set of rules do have a sort of adding up or internal logic to them. I would just note that the purpose of a baseline for predicting future budget outcomes and the purpose of a baseline for measuring policy changes and scoring purposes can sometimes come in conflict. And that is occurring now.

Senator ALLARD. Let us take AMT, for example, the Alternative Minimum Tax. They continually get extended every year. They will likely continue to be extended every year because they have both Republican and Democrat support. Why in the world don't we just figure that into the baseline, like an expiring program, for example? If you look at the record of the Congress, they are generally extended. There is sort of a group of expiring provisions that we bring forth every year that we just assume are going to be extended out every year. And yet we have a program out here that expires but we assume it is going to be extended, even though we do not even have a history in this Congress of extending that program.

So I think there is some inconsistency there, and I think it needs to be addressed. I know that we have certain assumptions built into the baseline. My point is that maybe we ought to take another look at these baseline assumptions and think if we are treating, when we extrapolate out these baselines, taxes the same way we are treating spending programs.

Mr. ORSZAG. Senator, what I would say is I think that a key principle should be that the cost of a particular policy path should be included in the budget process at some point, either at the time of enactment or when something is extended. The current scoring goals are intended to produce that outcome, so that for example on the revenue side, something that sunsets is not scored for the subsequent years when it is initially enacted. But then, if those provisions were extended, the cost shows up then.

So I think the important point is that the cost shows up in the budget process somewhere, either at the time of initial enactment or at extension.

With regard to other programs that are on the outlay side and are assumed to continue, a change that is made now will be continued in the initial scoring even if it expires within the budget window, so that the cost shows up today. Again, I think the important principle, regardless of how you do it is that the cost shows up somewhere.

Senator ALLARD. Don't you think that is an inconsistency?

Mr. ORSZAG. You could look at it either way. On the one hand, on the outlay side, even if you say something is going to stop with regard to some of the programs—

Senator ALLARD. Even though it expires, you assume it is going to continue on. It seems like an inconsistency there.

Mr. ORSZAG. But again the important point is that the cost of a change shows up somewhere. It adds up and it does not just disappear from the process. I think that is important to the integrity of the budgetary process.

Senator ALLARD. Mr. Chairman, my time has expired.

Chairman CONRAD. Let me just say, Senator Allard is asking important questions. This baseline, these baseline issues are thorny. They are difficult. Let me take a stab at this, and correct me, Director Orszag, if I misstate something.

You are required by the law to, on the baseline, continue current policy. On the tax cuts, Congress chose to sunset the president's tax cuts. They did that for a reason. They wanted to have more tax cuts and they wanted to reduce the appearance of the cost of them. And so they sunset them.

Of course, the CBO baseline has to take account of that change, because Congress has said these tax cuts end at a certain point. And at that point you are obligated by the law to terminate them. Isn't that the case? That is not a matter of choice.

Mr. ORSZAG. Senator, we follow the baseline rules that were initially set by law. That law has expired but tradition and norm suggest continuing them.

We are looking to you for guidance as to how the Budget Committees believe the rules should operate. One of the reasons that there is this tension or awkwardness now is that the size of the sunsets in tax provisions are much larger than they were historically. And that creates some of this question about the right baseline to be using for a variety of purposes. That is unusual historically. We have not historically had such a large component of the tax code expiring within the budget window.

Senator ALLARD. Would the Chairman yield on that?

Chairman CONRAD. I would be happy to yield.

Senator ALLARD. Look at No Child Left Behind, for example. That is up for reauthorization. In all of our assumptions, we always said that program is going to continue out. That is a pretty sizable program.

It seems to me there is an inconsistency there, because if that was a tax provision, and we know it is sunsetting, then we would assume that it is not going to be extended out.

So I think that maybe the Budget Committee ought to spend some time making sure that we treat both of those aspects of the ledger in a balanced way, that is my point.

Chairman CONRAD. It is a point that is not without merit.

Let me say this, on the tax cuts side of it, the reason CBO has to sunset the tax cuts and therefore change the baseline is because Congress sunset them. Congress made a choice. And Congress did it for a reason. Congress sunset the tax cuts because Congress wanted to have larger tax cuts, the administration wanted to have larger tax cuts than they really wanted to show in the out years.

Now on the spending side of the ledger, typically things that are put into law, for example all the mandatory programs, those are permanent programs. Medicare is not sunset. Social Security is not sunset.

So that is a problem that we are presented with.

Senator ALLARD. The same argument, we did sunset No Child Left Behind.

Chairman CONRAD. Maybe the Director can help us with that specific example.

Mr. ORSZAG. My understanding is that the spending associated with the No Child Left Behind program is on the discretionary side. So in the baseline it is a different set of issues than mandatory spending.

Senator ALLARD. My argument is not with the mandatory programs. My argument is with the discretionary programs that we put in. We sunset them and then do not treat them the same area as we would a tax cut. That is just the point I am making.

Mr. ORSZAG. If I could just comment briefly on the discretionary side, both to be clear about what we do in our baseline and also to point out that the discretionary spending programs generally operate in a different system than, for example, the pay-as-you-go rules. There are different rules that are associated with them.

In our baseline, one of the reasons that some people think that our baseline is biased the other way in a sense is that we assume that discretionary spending keeps pace with inflation. Historically such spending has grown more rapidly than that. So there are some who say the baseline understates likely discretionary spending because discretionary spending is likely to keep pace with population growth or something else.

But obviously you are raising a very important set of issues and I would very much look forward to working with you about both baseline and scoring issues as we move forward.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. Absolutely, Senator. Thanks for raising the question.

Let me go back to the question of the tax cuts because my able staff reminds those were done in reconciliation, which requires them to be terminated. They could not be made permanent because of the reconciliation rules. And they chose to do it in a reconciliation process because that allowed them to fast track it, to have limited debate, to have limited amendments. And so on the tax cut side, those were done under special rules that required their sunset.

The Senator raises a good point on the discretionary spending side of the ledger and I think the rationale has been you have a set of domestic spending initiatives. Even if one gets eliminated, they are replaced by others. If you look at discretionary spending, it has a base which tracks with what is happening to population growth, that tracks with inflation. And we are in a situation where we are not going to have that luxury.

The Senator I think, makes a point that is important here. We are not going to have that luxury. If we look ahead and look at the mandatory programs and the spillover effect on domestic discretionary programs, we are not going to be able to have those programs growing with inflation and population growth. It is not going to be affordable unless we do something substantial with the long-term entitlements and on the revenue side of the equation.

Senator ALLARD. Our surpluses that accumulate in Social Security will no longer be transferred to the general fund. And that is entirely right.

Chairman CONRAD. That is going to be a real moment of truth. Senator NELSON.

Senator NELSON. Good morning.

Senator Bunning is going to offer an amendment this afternoon on the Floor of the Senate that would eliminate the tax revenue that is paid on Social Security retirement benefits above a certain level. How would you characterize the effect of this upon the budget and the budget in the outlying years?

Mr. ORSZAG. Senator, we could get you the precise numbers but, as you know, Social Security benefits are partially subject to income taxation. That part of the tax code will grow more prominent over time because the thresholds are not indexed and so more and more people will be subject to them.

There would be implications also for both Social Security and Medicare, those programs, because the income taxes that are collected on Social Security benefits are currently dedicated both to the Social Security system and to Part A of Medicare.

Senator NELSON. We have heard that the impact would be something to the effect of reducing revenue by some $200 billion over a 10-year period.

Mr. ORSZAG. I could get back to you with the specific number. We cannot rule that out.

Senator NELSON. In order to approach this on a pay-as-you-go basis, to eliminate that tax but to find a source of revenue that would pay for that loss of revenue, do you have any suggestions?

Mr. ORSZAG. Senator, obviously there are many revenue options that are available to you. I am not even quite sure of the exact magnitude of the revenue change, so it would be premature to be providing you with many options.

I would also, as you know, point to the Joint Committee on Taxation as the lead agency for the revenue side of helping you on revenue options. But we would be happy to provide you with the options that you were interested in also.

Senator NELSON. I went on the Budget Committee in 1978 when I was a member of the House of Representatives. Of course, what I quickly realized that it was not just an economic document, it was a political document. Numbers can often be made to say whatever you want to say.

In the budget that you have presented, does the budget take into consideration additional expenditures for defense that would occur later on with regard to a supplemental being offered by the President?

Mr. ORSZAG. No, it includes only the enacted appropriations thus far this year.

Senator NELSON. Does the budget that you offered, does it assume anything other than existing law with regard to all of the tax cuts that are in place cease come 2010?

Mr. ORSZAG. All of the tax provisions that are scheduled to expire in 2010 do expire in our baseline.

Senator NELSON. So right there, in reality, what we would have to grapple with in working with you is enormous more spending in defense because we will see additional supplementals come, particularly with the increased effort in both Afghanistan and Iraq, and that we will see a huge amount of change in the revenue that will occur as a result of the changes in tax cuts.

So in the assumptions, would I be correct—and I will ask Dr. Orszag and you, Mr. Chairman—that where the current law in this budget would be built on assuming that the revenues are going to escalate higher as a result of the suspension of those tax cuts that are in place, the political reality is that some of those tax cuts are going to be reenacted and therefore the budget assumptions made by Dr. Orszag is going to be wrong because it is going to have a lot less revenue.

So right there, this is just a country boy talking, if you have increased expenditures and you have lowered revenues in what is the reality of the situation, the budgetary reality, you are going to have bigger deficits. Is this country boy saying something that make sense?

Mr. ORSZAG. You are absolutely correct, that higher spending and lower revenue leads to larger deficits.

[Laughter.]

Chairman CONRAD. Pretty sophisticated country boy over here.

Senator NELSON. You just take it from there.

Chairman CONRAD. We have calculated, Senator, that if you extend the President's tax cuts, if you fund the war, if you deal with the need to reform the Alternative Minimum Tax, if you adjust for the continuing supplementals, that is a $4.6 trillion difference from the CBO baseline over 10 years. And it is not to the positive side, it is to the negative side.

So the reality that we confront here, the ongoing war with the need to reform the Alternative Minimum Tax because it is going to sweep up tens of millions of people, the President's proposals to make the tax cuts permanent gives you a much different future than CBO is able to provide because of the rules that they are under, rules that we have imposed upon them by the way.

And on top of that you have, unfortunately, the retirement of the baby boom generation coming on, which is going to really put us in a deep hole unless we address it. And we have to address all of these things. We have our hands full. Dr. Orszag?

Mr. ORSZAG. Yes, you do have your hands full.

Chairman CONRAD. I would just like to go back to this question of tax cuts paying for themselves. The Treasury Department, their analysis said that you get an offset of about 10 percent. That is if you have a $200 billion tax cut, about $20 billion of it comes back to you because of the tax cut. So you are left with losing 90 percent of the revenue.

CBO has done the analysis that said the first 5 years you get back on favorable assumptions, favorable to tax cuts, you get back 22 percent of the tax cut. On less optimistic assumptions you get back nothing.

Central to the question of the effect of tax cuts and how much of the amount of the tax cut is paid for by the tax cut is the question of whether or not the tax cuts are paid for or not paid for. Many of the studies assume that the tax cuts are paid for either by other tax provisions or by cuts in spending.

What happens, Dr. Orszag, when the tax cuts are not paid for but are just added to the deficit? Then what do we see with respect to tax cuts paying for part of their amount?

Mr. ORSZAG. In that case, actually the sign can flip. So it is possible that the economic impact of a deficit financed tax change is actually negative rather than positive. The reason is that the tax change by itself can spur additional economic activity, lower marginal tax rates leading to more work effort. But you then have the drag on economic growth from a higher deficit and lower national saving. It is the net effect, and depending on the nature of the tax change it can go in either direction.

I would also note, Senator, that how tax cuts are financed consistent with that is absolutely critical to evaluating their full impact. The 22 percent figure that you were citing is actually the largest number for the CBO analysis for the first 5 years of a particular tax change that was studied. That analysis was applying one model and assuming that the cost of the tax change was offset by increases in tax rates after 10 years.

Different ways of financing—

Chairman CONRAD. I was trying to be as favorable as I could to the group that says tax cuts pay for themselves. It is very clear from every one of these studies, including the Treasury Department under this Administration, their own studies show that tax cuts do not come close to paying for themselves. And when they are deficit financed, they do not even have an additive effect but have a potential negative effect.

Is that not the case?

Mr. ORSZAG. I think what we can say is that financing tax cuts through deficits, rather than immediately financing them with reductions in government spending, tilt whatever you think toward it being more likely that the overall impact is negative.

Chairman CONRAD. Why does deficit financing alter the outcome on these studies? What is the drag that is created by deficits?

Mr. ORSZAG. Budget deficits tend to reduce national saving. Lower national saving means that we accumulate less capital. And that means that we grow slower than we otherwise would.

Chairman CONRAD. I know that Senator Allard would like to get into this discussion. I welcome you to it.

Senator ALLARD. In your discussion you talked about taxes in general. It was a broad discussion about taxes in general. But I do think to really appreciate what can happen in a dynamic tax situation, I think you have to recognize that some taxes have a lesser economic effect than others.

I think in your response, Doctor, you got to that. Take the child tax credit for example. Although it has a social purpose and we want to help young families that are getting started who have children, it does not have the same economic impact as expensing for small business, for example, that we had in our tax cut package, where when you expensed out $100,000 all of a sudden you had people going out and buying Bobcats, you had people going out and buying x-ray machines if they were doctors.

Chairman CONRAD. Does the Senator know Bobcats are made in my State?

Senator ALLARD. I do know that. I also know how to run one, too, Senator, and they are good.

All of this drives this economic activity. I visited with Dr. Greenspan on this issue and I just want to know how you would view something like an expensing provision for small business where you target the small business community and you generate all of this purchasing and everything with small business, it creates jobs, and keeps the economy turning.

Would you agree that there is a difference in the type of tax that you have? And some of them have a greater impact on revenues than others. And expensing, for example, on small business may have a very large impact on stimulating the economy. When you have a growing economy, it increases revenues, as we are seeing today, huge increase in revenues, to State governments as well as Federal Government.

Mr. ORSZAG. Senator, I think one of the most important points that I am hoping really does come across is that it is absolutely true that the effect of tax changes depend on the nature of the tax change, the specific provision, and also how the tax change is financed.

Three things actually. Where you are starting from, the nature of the tax change, and then how you finance it. And so just talking generically about tax changes is too broad. You need to get more specific.

Senator ALLARD. In other words, the level of taxation also has an impact, and that depicted on the Laffer Curve.

There is a place there on that curve where you maximize return to the Federal Government. You can have taxes too high and it really hurts your revenue, and you can taxes too low.

Dr. ORSZAG. That's right.

Senator ALLARD. And you should apply that to each tax. You cannot apply it to taxes, in general.

Mr. ORSZAG. Yes, the Laffer Curve, which is the now famous or infamous, depending on your perspective, depicts that.

The reason that CBO and others have reached the conclusion that in general tax cuts do not come close to paying for themselves, is that we believe that we are on the left side of that curve.

If you were on the other side of the curve, the conclusion could be flipped.

Senator ALLARD. Can I ask a question on that, Mr. Chairman?

Chairman CONRAD. Yes.

Senator ALLARD. In 2003, we had tax cuts. Do you think, in general, we were on the right side or the left side of that curve? Because if you look at the results on today's economy, it appears we were on the right side.

Mr. ORSZAG. Most of the analysis that has been done suggests that while there was some growth impact from the tax changes, especially in an economy that was weak a tax change and spur demand and that leads to economic growth in that kind of setting, that those changes were not sufficient to offset the direct impact. And thus, effectively we are on the left side of the curve.

Senator ALLARD. Thank you.

Chairman CONRAD. And the result is that those tax cuts did not pay for themselves, did not come anywhere close to paying for themselves, and were additive to the deficit and debt.

If we are dealing with reality rather than fantasy around here, tax cuts at current tax levels do not come close to paying for themselves, especially if they are deficit financed. Unfortunately, all of these have been deficit financed. We have had to borrow the money. And increasingly we are borrowing it from China and Japan.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman. I just had one followup on our earlier colloquy.

The Secretary clearly has extremely broad executive authority, clearly has rulemaking authority, and clearly has a very broad scope of initiative within which enterprises could be undertaken to pursue the goal of lower prescription costs through the Part D program.

Clearly this piece of legislation, the repeal of the non-interference clause, would not mandate how within the scope of that discretion and authority, the Secretary must act.

I just wanted to make sure that your comment to me, because it do not want to hear it other places as an argument unless I have clarified it with you, are you saying that there is no way with that piece of legislation that the Secretary could exercise his initiative to bring costs down? Or are saying that because the scope of it is so broad and that change alone provides little information about what will happen next, that from a scoring perspective you cannot put a dollar value on what would ensue?

Mr. ORSZAG. The latter, that is correct.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Chairman CONRAD. I would like to go back to the larger issue, if I could for a moment. Senator Allard, would you like?

Senator ALLARD. Yes, if I may.

Chairman CONRAD. If I could just go with a question and then we will come back to you, if that is OK.

I want to go back to the longer term issue that we face because we have been trying to focus on this committee on the longer term issues, challenges that we confront.

You earlier put up a chart that showed under one set of estimates we could be consuming all of what the Government spends now just on health care programs.

Mr. ORSZAG. Correct. In particular, if health care costs continue to grow over the next 50 years as rapidly relative to economic growth as they did over the past 50, that would be the outcome.

Chairman CONRAD. I am told that in your most recent baseline Medicare, for some inexplicable reason, has not grown as fast as was anticipated. Can you talk to us about what you are seeing with respect to Medicare expenditures? Why is it—you indicated part of it is Part D? In fact, I think if I heard you correctly you said the majority of it is Part D.

What other factors are contributing to Medicare not meeting the previous cost estimates? And can we anticipate that continuing?

Mr. ORSZAG. Projected Medicare spending is $445 billion lower now than in August 2006 over the 10-year window that was used at that point. The majority of that, $265 billion, is coming from Part D. And so let me talk about that briefly and then return to the residual component.

Part D is now estimated to cost less than it did in August for two reasons. First, the cost per beneficiary is lower. We now have actual data on experience with the program and again the PDPs, the prescription drug plans, are coming in with lower bids than we anticipated. And they are below last year's level, for example. That is the primary cause of that $265 billion. I think that something like over half, maybe closer to two-thirds of it, comes from that.

In addition there is, in the out years, a lower enrollment rate in Part D. That is because we now have more information on other sources of coverage available to Medicare beneficiaries. And so the share of Medicare beneficiaries that we project will take up the Part D benefit had been 87 percent. It is now 78 percent for those out years.

Chairman CONRAD. That is what you are anticipating would be the take-up rate? Instead of 87 percent, 78 percent? So there are savings there, as well.

Mr. ORSZAG. Correct.

Chairman CONRAD. How about in traditional Medicare, Part A and Part B?

Mr. ORSZAG. With regard to traditional Medicare basically what happened is—and we are still looking under the hood. But the change there looks like it is mostly concentrated in Part A, in hospital insurance. The previous baseline, consistent with experience over the previous several years, projected a more rapid growth rate. The actual cost numbers came in lower than that. So what happened in this baseline is we just had a one-off reduction in the level of costs and then roughly the same growth rate thereafter.

Chairman CONRAD. So this is more of a temporary thing, is your assessment?

Mr. ORSZAG. At this point, or at least for projection purposes, we are treating it as if it is a one-off change and then the growth rate resumes at the same time. So we are looking into exactly what the causes are of that lower rate.

There are a lot of things that are changing at the same time and obviously disentangling them all will take some time but we are actively working on it.

Chairman CONRAD. If you could inform the Committee when you reach conclusion on that matter, obviously that could be very significant if it is not just a one time—that would be very important to us.

Senator ALLARD.

Senator ALLARD. Thank you, Mr. Chairman. I want to follow the response on taxes and the impact it has had on the economy.

The fact is that we are seeing a pretty good jump in revenues at the Federal level and nearly all of the States are having a very good sizable jump in revenue. If it is not the tax cuts, what do you attribute that to?

Mr. ORSZAG. There are a variety of forces at work. Again, the tax changes could have caused some part of it. The question is whether they are the only cause.

Senator ALLARD. I do not think anybody is saying that. But would you say they contribute a significant part of it?

Mr. ORSZAG. They contributed some part to having the economy recover from the 2001 recessionary period. The tax cuts spurred demand and helped to boost growth.

With regard to the particular pick up in revenue over the last year or two, there are a variety of explanations being put forward. We do not have enough detailed individual information yet to evaluate all of them.

But for example, some things that people are putting forward as possible explanations, for any given level of overall economic activity, if that overall activity is more concentrated in higher income households than in middle-income households, then revenue will be higher than we projected for that given level of economic activity because our tax code is progressive.

We do not know yet, but it is possible that that is one explanation for why revenue is coming in higher than we projected. But there are others and we do not have the individual tax data yet to be able to give you a full answer.

Senator ALLARD. Let me move to Medicare Part D. In January of this year, CBO acknowledged market-based competitive bidding as one of the primary reasons for the significant decline in Part D spending of $136 billion to nearly 26 percent of what was projected.

Do you agree with that CBO finding? And do you believe that could be attributed to the market-based competition?

Mr. ORSZAG. Again, the bids are coming in and pricing is coming in better than anticipated and that is likely a reflection of the competition that is occurring in the private market.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. I would like to go back to the whole question of what stimulates economic growth because I think we would all acknowledge tax cuts in a certain environment help stimulate economic growth. When the economy is underperforming, tax cuts are stimulative. Spending is stimulative.

Would you agree with that, Dr. Orszag?

Mr. ORSZAG. In a weak economy, where firms have extra workers and plant and equipment ready to produce things if someone would just buy them, either additional spending or a tax reduction which then spurs private spending will boost economic activity.

Over the long term, the question is a much different one because the question then becomes how do you encourage a greater capacity of firms and workers to produce things rather than generating enough demand for them?

Obviously, the tax system is only one of many inputs into that question.

Chairman CONRAD. In fact, running large budget deficits is stimulative, is it not the case?

Mr. ORSZAG. In the short-term, but not in the long-term.

Chairman CONRAD. So in the short term, if you have a weak economy, running large budget deficits helps stimulate. But there is a drag effect over time.

Mr. ORSZAG. That is correct.

Chairman CONRAD. And that is why when you look at the question of tax cuts, tax cuts can be stimulative if conditions are—I would argue, in fact I proposed very significant tax cuts in 2001. I proposed about half as much as the President proposed, because I wanted to take the rest and deal with the Social Security shortfall.

But I think we all understand that under certain conditions both tax cuts and spending are stimulative.

The question I have been trying to raise is do tax cuts pay for themselves? I think both the academic research from the Treasury Department, from economists outside the Government, indicate they simply do not. They can offset part of their costs. But that offset is reduced if they are deficit financed.

Is that not the conclusion that we should reach if we are trying to do this on a rational basis?

Mr. ORSZAG. That is what the vast preponderance of analysis suggests.

Chairman CONRAD. Let me go to these larger questions once again, because if we are looking at the long-term imbalance in Social Security and contrast that with the long-term imbalance in Medicare, does CBO analysis show, as the GAO analysis showed, that the shortfall in Medicare is maybe seven times as much as the shortfall in Social Security?

Mr. ORSZAG. There are accounting questions regarding how you allocate shortfalls but there is no question that the Medicare inbalance, Medicare and Medicaid combined in particular, is substantially larger, many times larger than the Social Security one.

Chairman CONRAD. Have your people done any analysis on what we might do, a menu of options for how we could have savings in those accounts?

Mr. ORSZAG. Senator, we are actively working on various options for basically reducing cost growth in health care that you could evaluate. Let me just pause on that for a second because I think there is too aspects of it that are very important to emphasize.

One is I think it is a mistake to look at containing costs just within the Federal programs themselves, Medicare and Medicaid. The underlying driver of that cost growth, the costs in those programs, is the underlying rate of cost growth in the health sector as a whole. And tackling that problem is perhaps the fundamental fiscal challenge and an important economic challenge facing the Nation. So we need to be thinking about things that will restrain that cost growth.

The second point is I believe that there are opportunities to do that while still promoting innovation and imposing no harm on Americans' health. There is a variety of evidence suggesting that at the margin for each additional dollar we spend on health care, we do not get very much in terms of additional health benefits. That opens up the possibility that we could take some cost growth out of the system while not harming and perhaps even helping many Americans' health.

Chairman CONRAD. Let me just say, on behalf of the Committee, that we would ask you to come back to us as quickly as you can with options for saving money. And obviously, we would like to save money in a way that does not adversely affect healthcare outcomes. In fact, I believe there are places where we could actually save money and improve health care outcomes. I have talked to my colleagues about that many times with respect to better coordinating the care of the chronically ill.

Senator CARDIN.

Senator CARDIN. Thank you, Mr. Chairman. Dr. Orszag, welcome. Thank you very much for being willing to come forward and we congratulate you on your new appointment.

I congratulate you for being willing to come into the middle of this battle that we have going on regarding our budget, and I look forward to your help.

I want to cover two points, one on savings initiatives. You and I have worked in the past on improving savings rates in this country in a fiscally responsible way, targeting as many resources as possible to those who need the most assistance, our lower wage workers, and also increasing our national savings rate.

I hope that we will have a chance during the budget debate to talk about the impact of our savings rates on our short-term and long-term budget situation.

Let me ask a specific question on Medicare. I know that you have answered questions dealing with the pricing of prescription medicines in Medicare Part D. Your projections are a little lower as far as the Medicare spending is concerned. And there are certain aspects of the Medicare law on prescription drugs that I would like to get your help as to its impact on Federal spending.

The law requires that all of the Medicare Part D plans be administered by private insurance companies. There is no governmental insurance option. Statistics indicate that a Federal health care programs have for lower administrative costs than private health plans.

If the Federal Government offered a public option, would that have an impact on some of the cost issues? I believe that is one way in which we could bring down the cost of Medicare Part D, as we do of course in the other parts of Medicare where the Government provides services and private insurance can also provide them.

I am interested as to what impact seniors' confusion about Part D may have had on your projections. Many seniors in my community have not signed up for Medicare Part D because they quite frankly cannot figure it out. So are these projections taking into consideration that many seniors who perhaps should be in Medicare D are not, and that is contributing to some of our cost savings?

I know you have been asked this question in the past. But my comfort level is not quite there on how much we can save if we allowed Medicare negotiated price. Common sense and Economics 101 tell me that the larger the market, the lower the price will be. So if you can put forward a larger market to a pharmaceutical manufacturer, you are going to get a lower price.

So it seems to me there is a substantial savings that we can achieve for taxpayers if we allow the Government to negotiate based upon the fall market in the Medicare program.

I would hope that as we start our deliberations on this year's budget, where entitlement spending for Medicare plays such a large role, we will be able to get more information about policy changes that could have a major effect on saving taxpayers money without adversely affecting Medicare beneficiaries' access to needed services.

Mr. ORSZAG. Senator, first with regard to complexity. Before answering the specific question, I do want to emphasize that I think in a variety of areas the evidence is very strong that complexity causes significant problems, whether it is with regard to higher education programs or retirement savings programs. That for any given level of effort by the Federal Government, the more complex it is the less impact it has in terms of improving outcomes for households.

So finding ways of still achieving the same purpose through simplified and default and other options, I think is a broad theme that is worthy of a lot of attention.

With regard to the specific question of enrollment, and just to clarify, the new projections entail lower enrollment rates over the long-term primarily because we now believe that beneficiaries will have—more beneficiaries will have other good coverage for prescription drugs than Medicare Part D and therefore will not take up Part D.

But in the very short term, there's actually a higher level of enrollment now than we projected last August. So the 2006 numbers are coming in with somewhat higher enrollment than we had thought in August.

Again, just to come back to, I guess, the central question of negotiating authority, I want to again emphasize that the reason that negotiating authority just by itself, in the absence of other steps, does not generate a large cost saving in our view, is that by itself it does not tap the potential steps that could lead to those savings.

So there are other things that are unimaginable and you would had to carefully evaluate the pros and cons. But a lot of the comparisons that have been done, comparing for example the VA program to Medicare, the prescription drug plans under Medicare, ignores the fact that the VA program has a formulary and it also has access to basically a direct price intervention through the Federal Ceiling Price and the Federal Supply Schedule which requires private firms to offer to the Veterans Administration effectively the best price that they offer on private markets. Which is not a feature of the legislation that passed the House.

Senator CARDIN. Mr. Chairman, your patience.

I understand there are other moving parts here, and it is very important for Congress to consider them also. I could not agree with you more.

But basic economics tells me this: that if government is negotiating a price with a manufacturer and has a larger market share, then that in and of itself would generate a more favorable opportunity for the taxpayer than would 40 separate private companies each negotiating a price for their enrollees.

Mr. ORSZAG. The problem is that the Secretary does not really control that market share. Part D is a little bit above one-quarter of the prescription drug market. If the Secretary could walk into a negotiation and say if you offer me this discount that 25 percent of the market is going to go your way effectively, very significant price reductions could be imagined. But that is not what would happen under just giving the Secretary negotiating authority because the Secretary cannot prohibit or prevented the drug from being listed or not listed on the PDPs, the prescription drug plans.

So by itself, the Secretary would then be in the position of walking in and, unless there were other regulatory steps brought into the discussion, which would raise a different set of issues, saying I am here to negotiate prices but I will not really be able to control or steer toward you any additional drug purchases. And in that situation, it is not clear why the Secretary would succeed in getting any significant price reductions.

Senator CARDIN. We need to explore this in greater detail. Clearly Medicare Part D was designed to make it difficult for Government to get directly involved in these areas, in addition to the negotiating restrictions. The history of Medicare is different than that. So this is truly different than the history of Medicare.

As as we look at saving taxpayer dollars, we should be prepared to redesign the program to save taxpayer money without adversely affecting seniors' access to prescription medicines.

Thank you, Mr. Chairman.

Chairman CONRAD. Let me just go back to this point because we have a complex mix here on what is happening with Part D. We have lower plan bids. Some have said that one factor there may be overall prescription drug spending seems to be slowing. Do you anticipate or do you believe that that could be a factor here?

Mr. ORSZAG. That could be a factor, yes.

Chairman CONRAD. We also have been told that lower plan bids may be, in part, a business strategy by those offering the plans to capture market share. Could that be part of the reason we are seeing lower plan bids?

Mr. ORSZAG. It is possible. The market is, the top few plans account for a very large share of the existing market.

Chairman CONRAD. Let us talk about that a little bit. How many plans now, do you have this information at hand, how many plans do we have around the country? And what is the share of market for the top five?

Mr. ORSZAG. I know that the number of plans is quite high, and I believe that the share of the top five plans is also quite high. But I do not want to cite a number without being sure.

Chairman CONRAD. Does anybody on your staff here know what the top five plans would have, in terms of market share?

Mr. ORSZAG. We will get you that information. I have seen from other sources numbers that, the top five would be, I believe, even the majority of the market and perhaps well over the majority. But we will get you the precise number.

Chairman CONRAD. I think that is important to our understanding of what is going on here.

One closing question for me. Last week, Mr. Bernanke was here, the Chairman of the Federal Reserve, and he said this: Official projections suggest the unified deficit may stabilize or moderate further over the next few years.

Then he went on to say unfortunately, we are experiencing what seems likely to be the calm before the storm.

He went on to warn this committee that notwithstanding the likely improvement in the short term, that we remain on an unsustainable long-term path.

I would ask you, do you agree with the assessment by the Chairman of the Federal Reserve?

Mr. ORSZAG. Very much so. The Nation's long-term fiscal imbalance is quite serious and the sooner that policymakers address it the better.

Chairman CONRAD. I think that is the case. And that is the consistent message this committee hasten. It is the consistent message we got from the head of the General Accounting Office, from the Chairman of the Federal Reserve. And I am very hopeful that we find a way, Democrats and Republicans, to come together to face up to this long-term challenge and to do it sooner rather than later.

I think that is clearly in the national interest. Senator Gregg and I have been endeavoring to devise a process to address that. And we thank you very much for your testimony.

Are there any further questions from members? Senator Allard.

Senator ALLARD. Mr. Chairman, I do have a couple of things I would like to followup on, if I may.

I want to followup on our earlier discussion where you had said that you felt like the tax cuts that were put in place in 2003 actually were deficit financed tax cuts. If that's true—and then you went on further and said that would reduce savings. We have seen savings go down in that respect. But what we have not seen go down is long-term interest rates.

Before the tax cuts, the rates were hovering well over 5 percent. Since 2003 until now, they have been mainly around 4.5 percent, maybe on the high 4 percent side.

If we have damaged savings so much, how come those interest rates remain so low?

Mr. ORSZAG. That is a very good question. There are a variety of explanations that are being put forward.

Lower national saving means one of two things. It means either lower domestic investment or it means more borrowing from abroad. That is sort of an accounting identity.

So if we are only saving 1 percent of our income on that, it means we are only investing 1 percent of our income here in the United States or we are borrowing the difference from abroad.

Over the past several years there has been a very significant increase in the amount that we borrow from abroad. The reason that matters to the discussion is the mechanism for a given level of national saving affecting domestic investment is typically the interest rate.

So in short, what may be happening, or at least one explanation for what has happened, is as the world economy becomes more integrated and capital flows become easier across countries, the effect of domestic changes in budget outcomes, for example, is muted in terms of the interest rate effect and it shows up more in terms of international borrowing then a purely domestic mechanism.

Senator ALLARD. In that way, international borrowing may help our economy grow because it held our interest rates down.

Mr. ORSZAG. That is true, although I would note that foreigners do not lend us money for free. And so we do ultimately have to repay what we borrowed.

Senator ALLARD. But it is at a lower rate than it would ordinarily be.

Mr. ORSZAG. There is an interesting question about whether we are able, for a variety of reasons, to borrow at relatively low rates. In which case, the benefits of the investments that we can make with that borrowed money may exceed the repayments that we have to make. And there could potentially be some net gain from that. But it is smaller than the total.

Senator ALLARD. What are some of the other theories that could be used to explain that? You said there were several theories and you suggested this is one of them.

Mr. ORSZAG. That is one theory. Another theory is that, another prominent theory—and I probably should have mentioned in the same breath—that financial markets expect that whatever steps one takes on the budget, then it generates a certain projected outcome, that you all will take steps before a catastrophe hits to avoid that catastrophe. Therefore, they price that into long-term—

Chairman CONRAD. They are counting on us.

Mr. ORSZAG. Yes, it is all on you.

What is interesting about that is if that perspective is correct, then if at some point financial markets realize that is not the case, you will then break from their perception. And you could potentially have a significant adjustment at that point.

Anyway that is another explanation. There are others and I would be happy to sit down and discuss them in more length.

Senator ALLARD. Mr. Chairman, I know you are trying to wrap this up but I want to bring up the issue of military spending.

What you are projecting in the baseline is $145 billion on defense spending. We have already moved $70 billion over into 2007. It seems to me that that is pretty low. Around $100 billion is what we might expect in spending.

Do we need to take a look at the model that you are using for this? Or is this something we are not going to be able to deal with through model changes and it is just a problem we have with the way the Defense Department is coming in with their increased requests and emergency spending?

Mr. ORSZAG. A couple things quickly. First, which regard to the baseline, we include $70 billion in appropriated money because—

Senator ALLARD. In the $145 billion you do?

Mr. ORSZAG. $70 billion for 2007. And there is likely to be more money appropriated.

Senator ALLARD. Let me get this straight. I have here in my notes: CBO projects a 2007 funding level for the global war on terrorism of $145 billion.

Mr. ORSZAG. Oh, I am sorry, under an alternative path. Thank you.

So one of the alternatives, not the main numbers, but one of the changes in policies or the alternatives includes, yes, total of $145 billion for 2007.

I would say two things about the cost of ongoing operations, which obviously we are only talking about the fiscal cost. And I want to just focus on those and leave up to you other aspects of it.

The cost per month of ongoing operations appears, for the global war on terrorism, to be about $10 billion according to our information, and for the Iraq theater about $8.5 billion a month. We do not fully understand why those cost numbers are higher that they had been previously. And so that is one thing that needs to be better understood.

And in that context, the information that we have access to from the Defense Department and their systems do not allow us to have full insight into costing out both what is happening and what is likely to happen. And I understand that the Administration and others, and presumably this committee, are looking at different ways of trying to track both the budget authority and the actual spending that is associated with that particular set of defense activities, as opposed to everything else, more carefully.

Chairman CONRAD. Might I just, on this matter, Senator, say that in visiting with high level military officers part of what is happening, I am told, is we are living off the balance sheet. That is, that we are degrading equipment in a way that is going to come back in higher costs.

That is, when you are at this level of operations, the Army is going through Humvees, tanks, guns. The Air Force, at this high level of operations tempo, that the operations and maintenance expenses are going up because equipment is being degraded. That their requirement for replacement equipment is going up as this conflict is prolonged.

Senator ALLARD. I could see how that would happen because it is a pretty harsh environment.

Chairman CONRAD. Very harsh environment, very hot, and they sand, they tell me it is eating up engines. Of course, this affects all of the services. The leading edge obviously, the Marines and the Army, in terms of their equipment losses. The Air Force, they have just been up to see me and talking about the additional costs that they are experiencing.

I think as we have analyzed this so far, we think this $10 billion a month significantly understates the cost that is going to come in on us. And we will have to wait and see what the supplemental request of the President shows. But we are hearing $100 billion, somewhere in that range.

Dr. Orszag?

Mr. ORSZAG. I was just going to return in the spirit of being responsive to this committee to get back to you immediately on your question about prescription drug plans. The top three plans, I am told, account by themselves for more than half of the prescription drug plan and Medicare Advantage by enrollment by themselves. So the top five players would be over half.

Chairman CONRAD. I have suspected that that would be the case. You can see in industry group after industry group that you have three or four who overwhelmingly dominate. And I think over time we can come to expect, even though you have dozens and dozens of plans across the country, that in a relatively short period of time there will be concentration in the market and that we can anticipate that that will be the case. There will be three or four that will dominate probably somewhere around 80 percent of the market. It is rapidly moving in that direction. And that is basically the information you have confirmed for us.

Let me indicate, we had said that we would try to end at noon and we will try to be good to our word.

Dr. Orszag, outstanding first performance before the Senate Budget Committee. We appreciate so much the contribution that you are making there and your excellent staff, as well.

And Dr. Marron, we are so glad to see you as a continuing part of this team.

Thank you very much. The hearing is adjourned.

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

Senator Debbie Stabenow
Questions for the Record for Dr. Peter Orszag
Senate Budget Committee Hearing on CBO's January Budget and Economic Outlook
January 25, 2007

1. I introduced the "Lower PRICED Drugs" Act with Senator Lott in the last Congress and plan on reintroducing the legislation in the near future. Our bill would close loopholes in patent laws that are being used to delay the introduction of generics to the market.

While the average retail price of a brand name prescription drug was about $102 in 2005, the average retail price of a generic prescription drug was about $30. And, according to IMS Health, generic drugs cost, on average, 30% to 80% less than their brand counterparts.

Would increased utilization of generic drugs reduce spending on prescription drugs?

I will be asking CBO to consider the level of unrealized savings to federal programs due to delays in access of generic entry into the marketplace, and look forward to working with you.

2. Generic drugs have been extremely successful in bringing down the high cost of prescription drugs. However, although $10 billion worth of biotech drugs expired between 2004 and 2005, there is no legal pathway allowing for safe and effective competing alternatives in the marketplace.

Without a generic approval process, biologics are, in effect, granted permanent monopolies. The cost of some of these drugs is truly astronomical: Gleevec, a drug for leukemia, costs $28,500-$58,000 per year.

A CBO study from several years ago indicated that the availability of generic drugs has saved $8-$10 billion annually.

By all accounts the potential for savings in the area of biologics is even greater. The market is currently worth over $39 billion annually and is expected to grow to $90 billion by 2009. In 2006, the Medicare Part B program alone spent more than $5 billion on biologics -- even a small percentage savings would be large to the federal budget in dollar terms.

Do you agree that this is a promising area for real savings given the size of the market and the evidence that generic drugs have lowered the prices of small molecule drugs?

I look forward to working with you to get an estimate of the federal savings available from enactment of legislation establishing a legal pathway for biotech drugs.

Debbie Stabenow

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

February 5, 2007

Honorable Debbie Stabenow
United States Senate
Washington, DC 20510

Dear Senator:

This letter responds to the questions you asked following the Senate Budget Committee's January 25, 2007, hearing on the Congressional Budget Office's *Budget and Economic Outlook.*

You asked whether there are potential unrealized budgetary savings from an increased use of generic drugs. As your question suggests, the average retail price of generic drugs is considerably lower than the average price of brand-name drugs. That price differential manifests itself in federal programs. In the Medicaid program, for example, generic drugs make up about half of all prescriptions dispensed at retail pharmacies but account for only about 15 percent of drug spending. Given the price differences between generic and brand-name drugs, increased utilization of generic drugs would decrease spending on prescription drugs by federal programs and other payers. Such increased use of generics, however, might have effects beyond its immediate impact on federal spending, including an impact on incentives for pharmaceutical innovation.

You also asked whether an abbreviated approval process for so-called follow-on biological drugs could result in cost savings. CBO believes that establishing an abbreviated process for the Food and Drug Administration (FDA) to approve follow-on biologics has the potential to reduce drug spending. At the same time, however, CBO expects that the market for follow-on biological products will probably differ in important aspects from the current market for small-molecule generic drugs. For example, establishing that a brand-name product and a follow-on product are interchangeable could be more difficult for biological products than for small-molecule products. For that reason and others, the market shares of follow-on biologics and their price discounts relative to the brand-name products may be smaller than what is currently seen in mature markets for small-molecule generic drugs. In addition, it will take time for FDA to

Honorable Debbie Stabenow
Page 2

establish a new regulatory structure for approving follow-on biologics, and for the first follow-on products to work their way through that new structure. In anticipation of legislation addressing this issue, CBO is currently gathering information to estimate the potential budgetary savings from establishing an abbreviated approval process for follow-on biologics.

I hope this information is helpful to you. I would be happy to meet with you to discuss these issues further, and I very much look forward to working with you and other members of the Budget Committee during my term at CBO.

Sincerely,

Peter R. Orszag
Director

cc: Honorable Kent Conrad
Chairman
Committee on the Budget

Honorable Judd Gregg
Ranking Member

DEFINING OUR LONG-TERM FISCAL CHALLENGES

TUESDAY, JANUARY 30, 2007

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, Wyden, Stabenow, Menendez, Cardin, Sanders, Allard, and Bunning.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. I bring the hearing to order.

I want to welcome everyone to the Budget Committee today. I want to particularly welcome our distinguished witnesses. Dr. Robert Reischauer, the President of the Urban Institute and the former head of the Congressional Budget Office; Robert Greenstein, the Executive Director of the Center on Budget and Policy Priorities; and Dr. Eugene Steuerle, a Senior Fellow at the Urban Institute. I very much welcome you all here and we appreciate your guidance to the committee.

Let me begin with a quote from the Federal Reserve Chairman Bernanke in his testimony earlier this month to this committee. In describing the urgency of addressing our deteriorating budget outlook, he said one might look at these projections and say well, these are about 2030 and 2040 and so we really do not have to start worrying about it yet. But, in fact, the longer we wait, the more severe, the more draconian, the more difficult the adjustments are going to be. I think the right time to start is about 10 years ago.

Federal Reserve Chairman Bernanke on Budget Outlook

"... [O]ne might look at these projections and say, 'Well, these are about 2030 and 2040 and ... so we don't really have to start worrying about it yet.' But, in fact, the longer we wait, the more severe, the more draconian, the more difficult ... the adjustments are going to be. I think the right time to start is about 10 years ago."

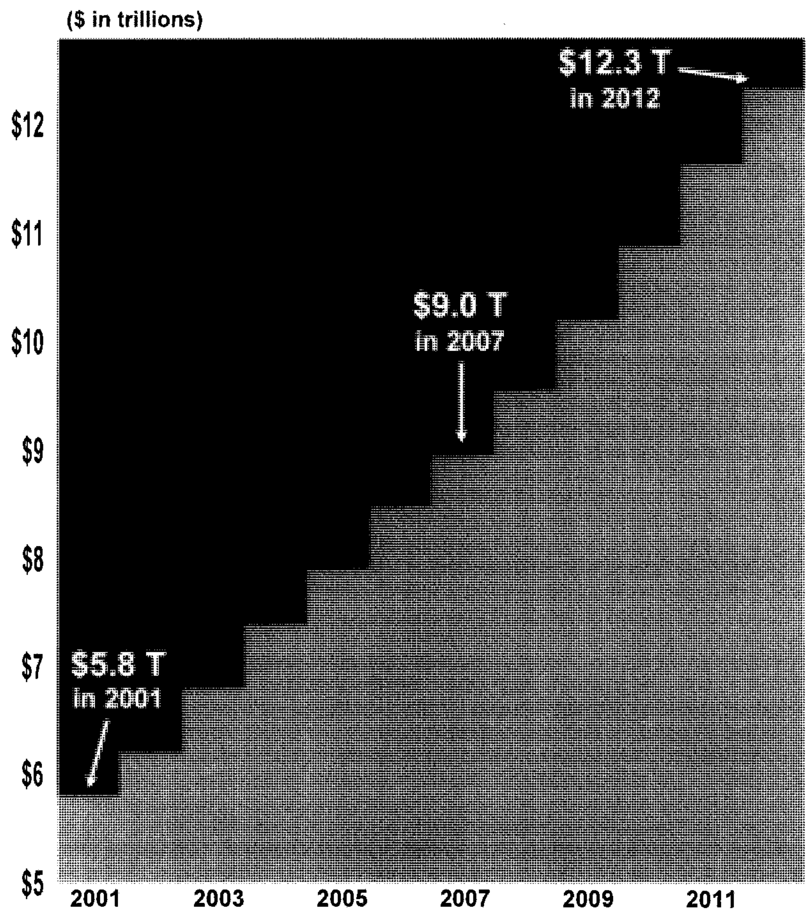
–Federal Reserve Chairman Ben Bernanke
Testimony before Senate Budget Committee
January 18, 2007

I think Chairman Bernanke had it about right.

We are now facing, as this next chart shows, a wall of debt. At the end of 2001 we had a gross debt for the country of $5.8 trillion. Under CBO's adjusted baseline we can see that gross debt will reach $9 trillion by the end of this year. And if we continue on this course, gross debt is projected to sore to $12 trillion, more than $12 trillion by 2012. All of this really at the worst possible time, right before the baby boom generation retires.

Building a Wall of Debt

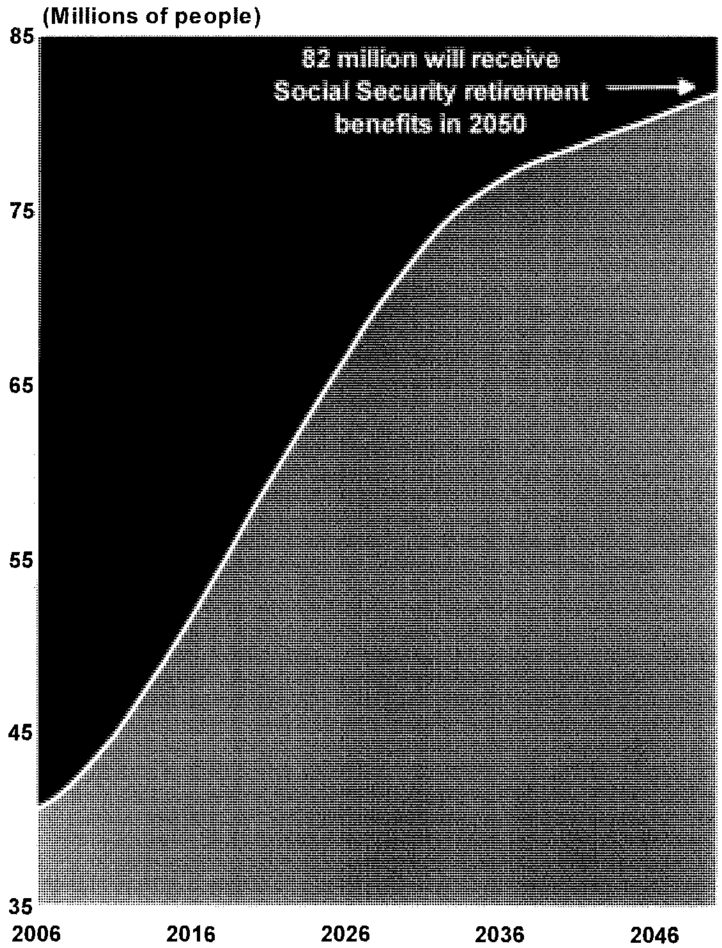
Gross Federal Debt Soars



Source: OMB, CBO and SBC Democratic staff
Note: CBO January 2007 estimate with tax cuts made permanent, AMT reform, ongoing war costs, Bush defense buildup, and without extension of 2007 emergency funding.

The number of Social Security beneficiaries is projected to more than double to some 82 million people by 2050. This is the trajectory that we are on. I call this the demographic tsunami. You can see all of these people have been born. This is not a matter of a projection. These people have been born. They are alive today. They are going to retire. They are going to be eligible for Social Security and Medicare. There is no way around that.

Number of Social Security Beneficiaries Explodes with Retirement of Baby Boom Generation



Source: 2006 Social Security Trustees Report
Note: OASI beneficiaries

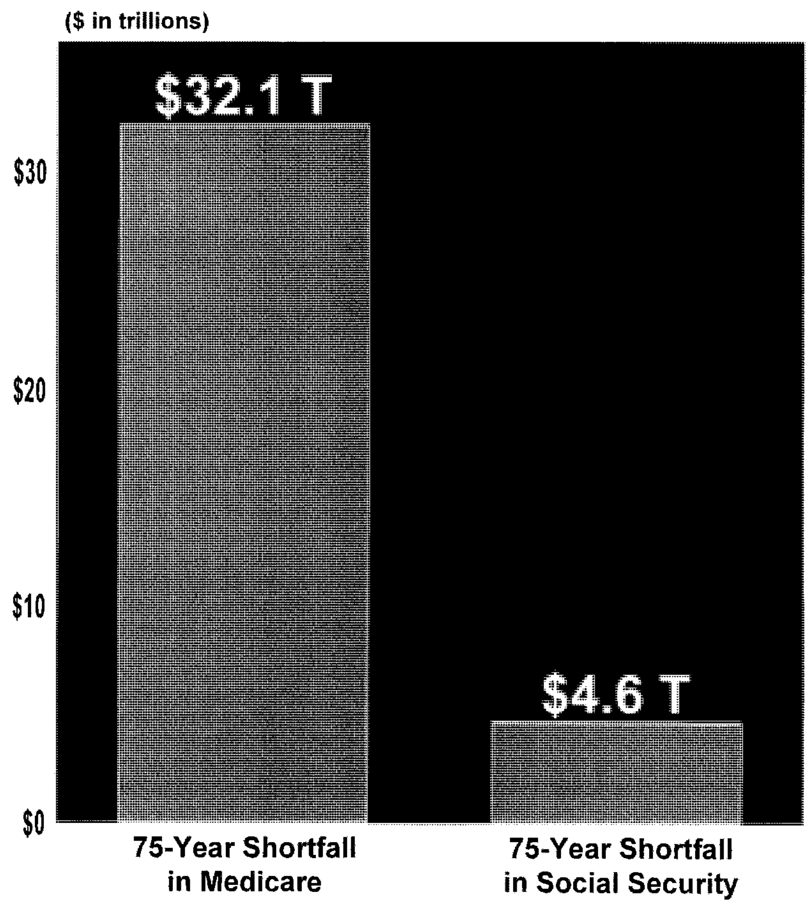
May 9

We need to remember that Social Security is not the biggest budget challenge. Because of rising health care costs over the next

75 years, the shortfall in Medicare is seven times the shortfall in Social Security. The shortfall, the projected 75-year shortfall in Social Security is $4.6 trillion. The 75-year shortfall in Medicare is over $32 trillion.

Comparing Long-Term Costs of Medicare and Social Security

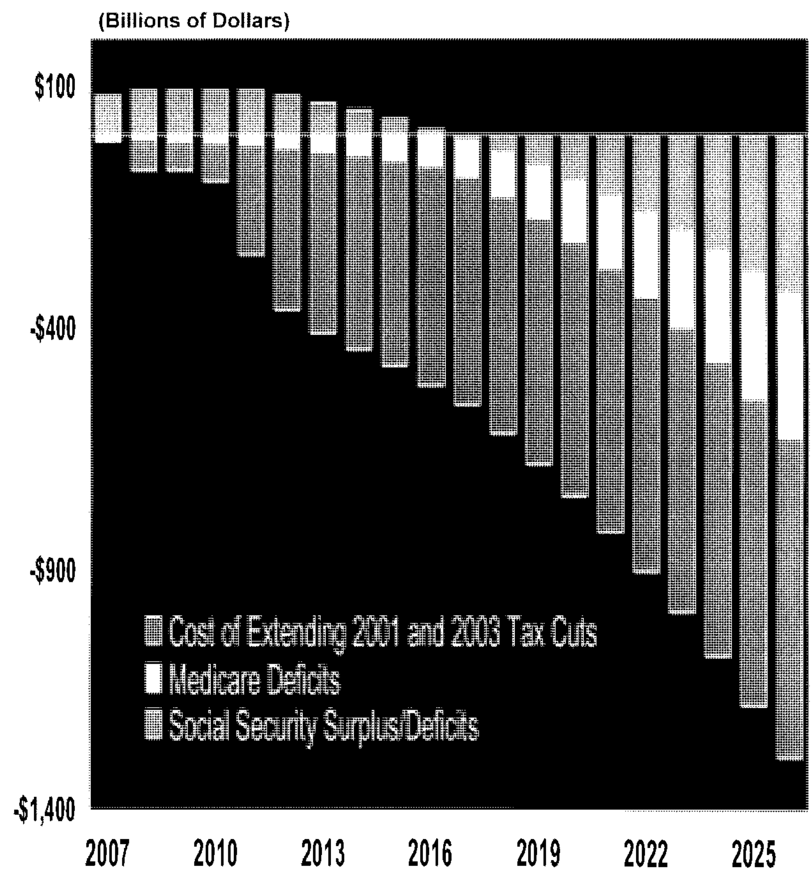
Present Value of Costs Over Next 75 Years



Source: Social Security Trustees 2006 Annual Report

But we do not just have an entitlement problem. We also have a revenue challenge. If all of the President's tax cuts are made permanent, the cost will explode at the very time the cash surpluses in Social Security and Medicare become deficits. In other words, the President's tax cuts will dramatically worsen an already deteriorating long-term budget picture.

Tax Cuts Explode as Trust Fund Cash Surpluses Become Deficits
FY 2007-2026



Source: Social Security Trustees 2006 Annual Report, CBO, CBPP, and SBC Democratic staff

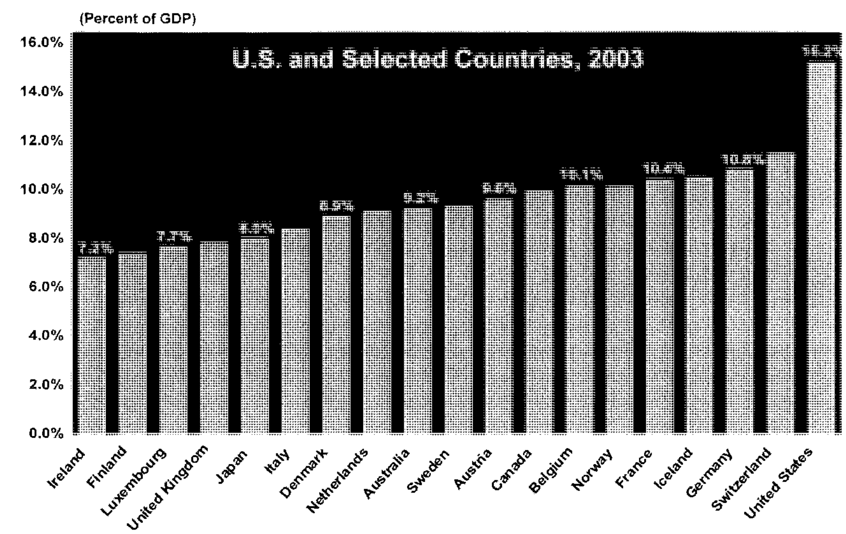
Jan 10

This chart, I think, is extremely important for my colleagues and for the public to understand. The green part of these bars is the Social Security surplus that then turned to deficits. The blue are Medicare, Medicare deficits. And red is the cost of making permanent the tax cuts from 2001 and 2003.

This is not a pretty picture because what it shows is right now Social Security is throwing off big surpluses. But when those turn to cash deficits, at that very time the cost of the President's tax cuts explode. The combined effect takes us right over the cliff.

Since so much of our long-term budget shortfall can be attributed to rising health care costs, health care reform has to be at the heart of any solution. Our health care system is not as efficient as it should be. The U.S. is spending far more on health expenditures per capita than any other country in the developed world. For example, the U.S. spent $5,711 on health care expenditures per capita in 2003 compared to $2,100 in Finland. Despite this additional health care spending, health outcomes in the U.S. are no better than health outcomes in the other OECD countries.

Total Health Expenditures as a Share of GDP



Source: Organization for Economic Co-operation and Development, October 2006

You can see, I just picked out Finland. Finland is at the low end. But you can look at all of the major countries of the developed world. The United Kingdom, they are just over $2,300 per capita, less than half of what we spend, all the way up to Switzerland. You can see they are $3,800, still far below us.

The country that is closest to us is Luxemburg, just under $4,000 per capita.

As we see the same thing when we look at health care expenditures as a share of our gross domestic product. For example, the U.S. spent 15 percent of GDP on health care expenditures in 2003. We believe we will be at about 16 percent of GDP this year compared to Ireland, 7.2 percent. The next highest to us is Switzerland at 11 percent of GDP, 11 percent of GDP. This year we are at 16 percent.

If we were 11 percent of GDP instead of 16 percent, we would save $800 billion in 1 year.

Clearly, just slashing Medicaid and Medicare is not the answer. One area, I believe, we need to focus on is the fact that about 5 percent of Medicare beneficiaries use half of the money. That is, I think, a startling and powerful statistic. Approximately 5 percent of Medicare beneficiaries use half the money. These are the chronically ill. They are people with multiple serious conditions. I think we are learning more and more. If we focused on that category, we could both improve health care outcomes and save money.

I believe our fiscal problems are not insurmountable. We can put our fiscal house back in order but it is going to take a good faith effort on everyone's part. And both political parties, and those of us who represent individual states, and those of us who have a party label by our name, I think all of us have to be prepared to give up on some of our fixed positions if we are going to make long-term progress.

With that, I want to turn to my colleague, Senator Allard, who is filling in ably for the ranking member of this committee, Senator Gregg, who could not be with us this morning.

Welcome, Senator Allard.

OPENING STATEMENT OF SENATOR ALLARD

Senator ALLARD. Thank you, Mr. Chairman.

I would like to join you in welcoming the panel members. I am looking forward to your testimony, and I know it is not always easy to put your personal schedules aside to be able to testify before this committee. But we have an important subject before us and I do commend the Chairman for his efforts in trying to deal with these long-term liabilities.

It is not really news to anybody. The Congress has known this has been coming on for a long time. But there has been an unwillingness for the Congress to respond to these issues. So I do appreciate the leadership that Senator Conrad is bringing forward as Chairman of the Budget Committee.

The baby boomers are going to start retiring in 2008. That is next year. If we look at the population growth of those 65 and over the numbers are staggering. In 2005 we are looking at 37 million. We see that doubling in 30 years, so that in 2035 we have 75 million people that are going to be pulling on our entitlement programs, which are directed to an aging population. That is Social Security, Medicare, and Medicaid.

When this was set up in the 1960's we had one beneficiary for every 5.1 workers and now have about 3.3 workers for everybeneficiary.In 2035, when we are projecting 75 million, there will only be 2.1 workers for each beneficiary or retiree.

It is a huge problem that we have before us. Under current law the mandatory spending will grow at an average of 6.1 percent per year during 2007 to 2016, reaching somewhere around $2.5 trillion.

But the entitlements, as the Chairman pointed out with his charts, are the real problem. We simply have to establish a will in this Congress to deal with the huge numbers that we are looking at with Social Security, Medicare and Medicaid.

If we look at Social Security, Medicare, and Medicaid, unless something is done, as a percentage of gross domestic product, spending on just these three programs is going to grow higher than one-fifth of the economy. Here is what we are looking at: in 2010 it will make up about 9.5 percent of gross domestic product. In 2030, about 18 percent of gross domestic product. And in 2050, 25 percent of gross domestic product.

But the astounding thing about it is not only are the percentages increasing as a percentage of gross domestic product, but gross domestic product is growing at a phenomenal rate. If you look at the growth of our entire economy from 2003 to now it has grown in an amount equal to the size of the entire Chinese economy. And so these are figures that are being extrapolated on top of a very fast-growing economy that we have currently.

I am not saying it is always going to be there, but our economy seems to be perking along pretty well, and I do not see any signs of it letting up. And when you look at those percentages and look at the growth of the gross domestic product, it is just phenomenal.

This problem is serious, and I do not see us being able to tax our way out of it. I think it is going to take a balanced solution. We are going to have to look at a number of things to do to begin to resolve this commitment. It will continually add to our deficit and, as a result, add to our total debt.

Some things have been done in an attempt to address this problem by the previous Chairman, Senator Gregg, with his SOS bill that he introduced last year. I think that there are some bipartisan groups looking at a commission to put some entitlement recommendations before the committee. While Social Security is a problem, Medicare and Medicaid is a greater problem and a much more complex issue to solve from my perspective, and I think most everybody would agree with that.

But I think maybe we need to start off with a simple solution with Social Security and then begin to address Medicare. But we cannot delay it because Medicare is going to be a problem here shortly and it is going to be a huge problem when it hits us.

So I again commend the Chairman for running these series of hearings and look forward to your testimony.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Allard.

Next we will turn to our witnesses and we will hear from each of them in turn, and then open the panel to questions from the members.

Welcome, Dr. Reischauer. It is always good to have you back before the committee.

Are we going to start with Gene or with Bob?

Welcome.

STATEMENT OF ROBERT GREENSTEIN, FOUNDER AND EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. GREENSTEIN. Thank you, Mr. Chairman.

Yesterday, we released new long-term budget projections through 2050 that incorporate the new CBO report that came out last week and take into account recommendations from a number of the Nation's leading budget experts.

There are five key findings. First, the Nation's budget policies are unsustainable.

Second, the main source of rising expenditures is rising health care costs throughout the U.S. health care system and demographic changes that would drive up spending for the "big three": Medicare, Social Security, and Medicaid.

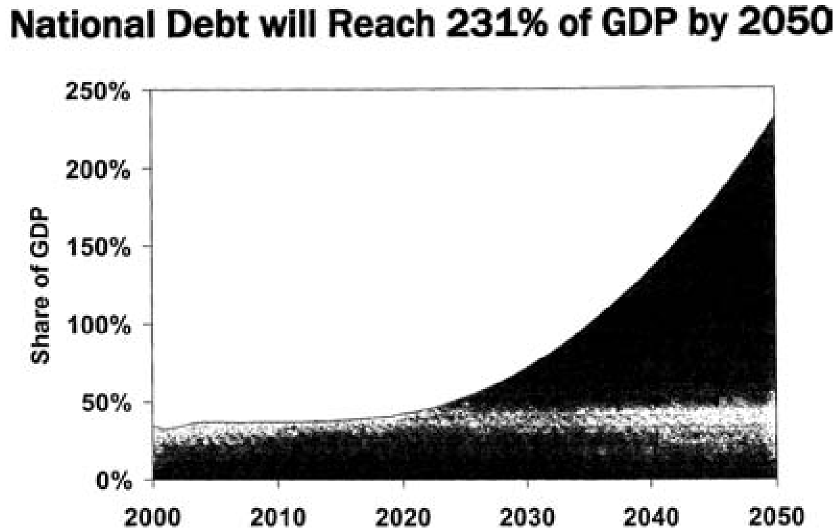
Third, increases in health care costs per beneficiary in Medicare and Medicaid mirror increases in costs in the overall U.S. health care system and a solution to the long-term fiscal problem will necessitate reform in the overall health care system.

Fourth, Federal programs other than Medicare, Medicaid, and Social Security, including entitlements other than the big three, are projected to shrink as a share of the economy and are not contributing to the problem.

Fifth, the tax policy decisions you must make in coming years will have a large impact.

Let me take each of these five areas in a little more detail.

Our projections show that if you stay on the current course, make no changes in the "big three", make all the tax cuts permanent and, continue relief from the AMT without paying for it, deficits will reach 20 percent of GDP by 2050 and the national debt will reach 230 percent of GDP by 2050, as this graph shows.



Source: CBPP projections based on CBO data.

Another way of measuring the size of the problem is to look at what analysts call the fiscal gap, which is the amount of program reductions or revenue increases needed to ensure that the debt as a share of the economy is no higher in 2050 than it is today. Under our projections, the fiscal gap is 3.2 percent of GDP.

Now what that means is that stabilizing the Nation's finances would require budget cuts or tax increases starting immediately equal to 3.2 percent of GDP per year. That would mean budget cuts and/or tax increases totaling $460 billion dollars in 2008 alone, because that is 3.2 percent of GDP. That is how big the problem is.

Second, health care costs rising throughout the health care system and demographic changes will cause Medicare, Social Security, and Medicaid to rise by 2050 by a projected 13 percent of GDP.

Third, the growth in Medicare and Medicaid costs mirrors and is driven to a large extent by cost growth in the health care system as a whole. For the past 30 years the average annual rate of increase in Medicare and Medicaid costs per beneficiary has been very close to the rate of increase in health care growth per beneficiary systemwide.

This is why Comptroller General David Walker has testified, and I am quoting, "Medicare and Medicaid cannot grow over the long term at a slower rate than the rest of the health care system without resulting in a two-tier health care system." And he continued "To address the long-term fiscal challenge, it will be necessary to find approaches that deal with health care cost growth in the overall health care system."

No. 4, programs other than the big three. The new CBO forecasts that came out last week shows that entitlements other than the big three as well as domestic discretionary programs will fall through 2017 modestly as a share of GDP. That continues a trend of the past 30 years and is expected to continue beyond 2017. This is why it is not really accurate to speak of a general entitlement crisis rather than to focus on the projected increases in Medicare, Medicaid and Social Security and the factors that drive them.

CBO's Projection of Growth in Various Parts of the Budget, 2007-2017

Program Area	Growth as a Share of GDP, 2007-2017
The "Big Three"	+ 1.8 %
All other entitlements	- 0.3 %
Domestic discretionary	- 0.8 %

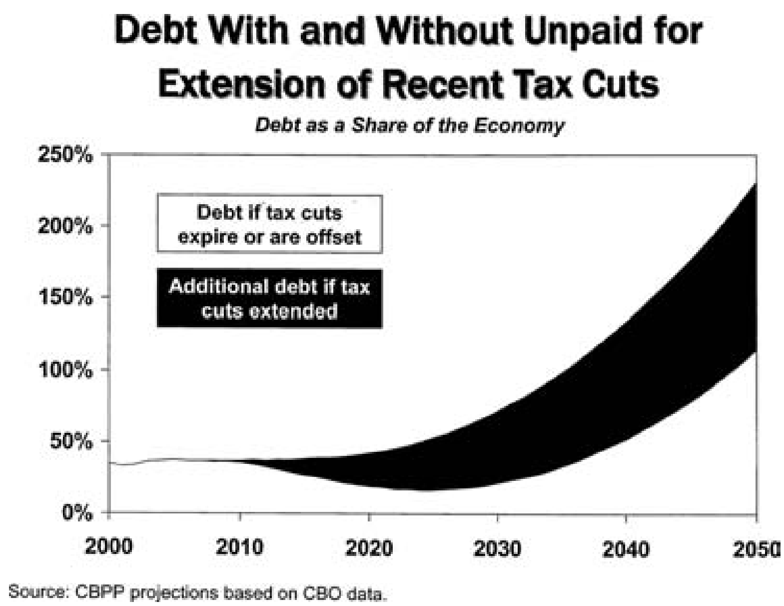
Source: Congressional Budget Office January 2007 baseline, adjusted to reflect extension of expiring tax provisions that affect refundable tax credits.

Finally, the tax policy decisions Congress must make over the next few years will have large effects. Specifically, allowing the recent tax cuts either to expire as scheduled or to continue them but to pay for their costs under PAYGO would reduce the long-term fiscal gap by three-fifths. The tax cuts, when fully in effect, will cost about 2 percent of GDP. The fiscal gap is 3.2 percent of GDP. Either letting them expire or extending them but paying for it will shrink the long-term fiscal gap from 3.2 percent to 1.3 percent of GDP.

Or stated another way, making the tax cuts permanent without paying for them will double the fiscal gap through 2050 relative to what it otherwise would be.

Why is that effect so large? Because the decision is occurring in the next few years. And if one achieves deficit reduction of about 2 percent of GDP in the next few years, after 2010, that effect quickly compounds year by year in terms of debt and interest payments and ultimately reduces the deficit by significantly more than 2 percent of GDP.

It is simply an illustration of the larger point which you made, Mr. Chairman, the sooner you act, both on the revenue and the entitlement side, the larger the long-term effect and the smaller the depth of the reductions that ultimately have to be made.



Our bottom line is that it is politically implausible to close a gap of this size either solely by cutting programs or solely by raising taxes. Doing so would require the equivalent of an immediate permanent 18 percent increase in tax revenues or an immediate permanent 15 percent cut in all programs, including Social Security, Medicare, defense, antiterrorism activities, education, veterans benefits and the like. All parts of the budget have to be on the table and systemwide health care reform must be part of the solution.

Let me close with a few quick policy observations. As you noted, to make these kinds of changes in health care, taxes, and Social Security is going to require a large difficult bipartisan agreement which may take a few years to build the basis for. But some immediate, more modest, but still important steps could be taken. And there are some immediate things one wants not to do in order to keep the problem from getting worse.

So a few very quick suggestions. No. 1, I would seriously consider the medications for Medicare savings in the Medicare Payment Advisory Commission, of which Mr. Reischauer is a Vice-Chairman. I would seriously consider the revenue options in the report the Joint Tax Committee provided to Congress about 2 years ago, which has a series of options to narrow or curb unintended or unproductive tax expenditures and to improve tax compliance.

Third, I would consider a report issued last week by the Urban Institute Brookings Tax Policy Center that provided a series of options for revenue neutral reform of the Alternative Minimum Tax.

I note here that there has been discussion lately of AMT repeal. If the 2001 and 2003 tax cuts are not extended, AMT repeal would cost $800 billion over the next 10 years. If they are extended, it would cost $1.5 trillion over the next 10 years. And even continuing the current practice of providing an AMT patch each year without paying for it is becoming increasingly expensive and fiscally imprudent. On that course, it will cost you $70 billion a year by 2010 and more thereafter.

I would also consider freezing costly expansions not yet in effect. For example, two tax cuts that President Bush did not request, that were added on top in 2001, are only partially in effect now. They are slated to triple in size between now and 2010. These are two income tax adjustments.

Analysis by the Tax Policy Center shows that nearly two-thirds of these tax cut benefits not yet in effect would go to the 0.3 percent of Americans over $1 million a year, 90 percent will go to the 4 percent of Americans over $200,000 a year. If you simply held them at today's levels, and did not take away a dollar in tax cuts from anyone who is getting it, but did not allow them to triple in size between now and 2010, you would save $13 billion in the next several years, which is about the amount needed to avert deep cuts in the State Children's Health Insurance Program that will occur if SCHIP is frozen for the next 5 years at the Federal budget baseline.

Finally, I would seriously consider, across the Government, replacing the traditional Consumer Price Index with the new improved alternative CPI that the Labor Department has developed that measures inflation a little more accurately. I am talking about things from Social Security COLAs to the indexing of the tax code, evenhanded across the Government.

The new CPI rises a few tenths of a point per year more slowly than the traditional one. The savings initially are small. They grow over time when you need them as your fiscal problem expands. And it really should not be viewed as a benefit cut or a tax increase. It is simply doing what the law currently intends, adjusting for inflation rather than over-adjusting for inflation.

With that, I will conclude. Thanks for inviting me today.

[The prepared statement of Mr. Greenstein follows:]

TESTIMONY OF ROBERT GREENSTEIN
Executive Director
Center on Budget and Policy Priorities

before the
Senate Budget Committee

January 30, 2007

I appreciate the invitation to appear before you today. I direct the Center on Budget and Policy Priorities, a nonprofit policy institute that conducts research and analysis on fiscal policy matters, as well as on programs and policies for low-income families and individuals.

Last winter, the Center was asked by the Carnegie Roundtable on Economic Security to review all long-term budget projections that had been conducted, assess their strengths and weaknesses, examine the latest data, and construct new long-term projections. While we presented initial results to the Roundtable in May, this is a task we have worked on for close to a year. As part of this effort, we have shared our methodology and sought comments and recommendations from many of the nation's leading budget experts, including a number of former directors of the Congressional Budget Office. We released yesterday the analysis and projections that are the product of this enterprise, and I am pleased to present them to you today. These new budget projections extend through 2050.

The projections, based heavily on data and estimates from the Congressional Budget Office, are deeply disquieting. They show that the nation's budget policies are unsustainable. Deficits and debt will grow to unprecedented and dangerous levels if policy changes are not made.

The new projections also shed light on the sources of these problems and on the types of changes that would be needed to address them responsibly. Our principal findings are the following:

- The main sources of rising expenditures are rising health care costs (throughout the U.S. health care system) and demographic changes, which together will drive up spending for the "big three" domestic programs — Medicare, Medicaid, and Social Security.

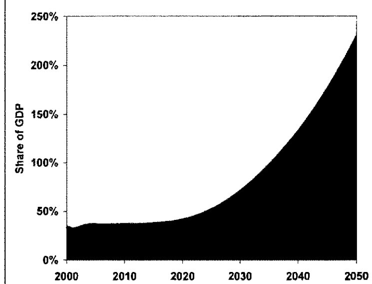
- Increases in health care costs per beneficiary in Medicare and Medicaid essentially mirror increases in costs per beneficiary in the overall U.S. health care system. As Comptroller General David Walker has pointed out, a solution to the long-term fiscal problem will require not only difficult choices to reduce programs and increase revenues, but also fundamental changes in the entire U.S. health care system.

- Tax policy decisions that Congress will face in coming years will have a substantial impact on the magnitude of the long-term problem. If Congress lets recent tax cuts expire by 2010 as scheduled or extends them (in whole or in part) but offsets the costs, the size of the fiscal problem through 2050 will shrink by 60 percent. This is because the resulting deficit reduction would begin in the next few years and have a steadily increasing impact on federal interest payments with each passing year. As a result, it would reduce long-term deficits by increasing amounts over time. Even so, the budget would remain on an unsustainable fiscal path.

- Federal programs *other than* Medicare, Medicaid, and Social Security — including entitlement programs other than the "big three" — are not expected to grow rapidly. To the contrary, these programs will shrink as a share of the economy and thus will consume a smaller share of the nation's resources in 2050 than they do today. These programs thus do not contribute to the long-term problem.

FIGURE 1

National Debt will Reach 231% of GDP by 2050



Source: CBPP projections based on CBO data.

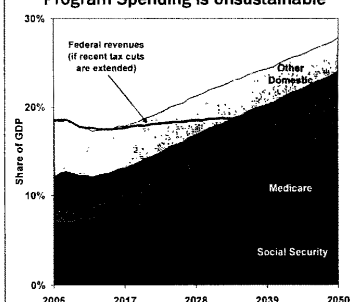
Current Budget Policies are Unsustainable

The nation's budget policies are unsustainable. Our projections show that if current budget policies are continued (e.g., if current laws governing Medicare, Social Security, and other programs remain unchanged, the 2001 and 2003 tax cuts are made permanent, and relief from the Alternative Minimum Tax is continued), deficits will reach about *20 percent of the Gross Domestic Product* by 2050, and the national debt will climb to *231 percent of GDP* by that year, or more than twice the size of the U.S. economy. Debt-to-GDP ratios in this range are unprecedented in the United States, even during major wars.

Debt at this level would seriously damage the economy. It also would place severe strains on the federal budget. For example, by 2050, simply paying interest on the national debt would consume more than half of annual projected federal revenues.

FIGURE 2

The Current Path of Federal Revenues and Program Spending is Unsustainable



Source: CBPP projections based on CBO data.

Another way of measuring the size of the problem is to examine the magnitude of the long-term *fiscal gap*. The fiscal gap represents the amount of program reductions or revenue increases needed over the next four decades to ensure that the debt, measured as a share of the economy, is no larger in 2050 than it is today. Under our projections, the fiscal gap equals 3.2 percent of projected GDP through 2050. Hence, stabilizing the nation's finances through 2050 would require annual tax increases or budget cuts equal to 3.2 percent of GDP, starting with tax increases and budget cuts totaling *$461 billion in 2008 alone.* ($461 billion equals 3.2 percent of projected GDP for 2008.)

As these figures suggest, eliminating a fiscal gap equal to 3.2 percent of GDP would be very difficult. Even so, some may wonder how it is that the nation could reduce the debt in 2050 from 231 percent of GDP to its current level of 37 percent of GDP simply by making annual changes equal to 3.2 percent of GDP. This is possible if the changes *start immediately*. If we instituted these revenue increases or program reductions this year, we would begin running surpluses rather than deficits, which would decrease rather than increase the national debt. The reductions in the debt, in turn, would reduce interest costs in every year through 2050, bringing the "miracle of compound interest" to bear on the budget problem. Compound interest also can work against us, however: if little or no deficit reduction is enacted in the near future, substantially larger deficit reduction will be required later.

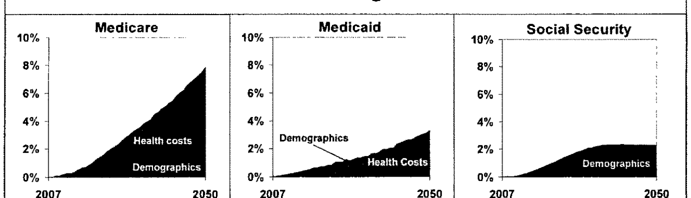
Health Care Costs and Demographic Changes — Not Entitlements Generally — Account for Rising Expenditures

The main sources of rising expenditures are rising costs *throughout* the U.S. health care system and demographic changes, with health care costs playing the larger role. Together, these two forces will cause the "big three" domestic programs — Medicare, Social Security, and Medicaid — to grow considerably faster than the economy. Collectively, these three programs are projected to grow by slightly more than 13 percent of GDP between now and 2050. Medicare is by far the largest contributor to the overall growth in expenditures through 2050 because it bears the full brunt of both demographic changes and health care costs. (See Figure 3.)

All other programs, including all entitlement programs other than the "big three," are projected as a group to grow more slowly than the economy in coming decades and consequently do not contribute to the projected rise in deficits and debt. The new Congressional Budget Office forecast shows, for example, that, taken as a whole, entitlements other than the "big three" are projected to remain constant in real per-capita terms between now and 2017 and to fall slightly as a share of

FIGURE 3

Sources of Cost Growth in the "Big Three" as a Share of GDP



Source: CBPP calculations based on CBO data.

Note: "Demographics" denotes the program growth that would occur solely due to demographic changes if per-beneficiary health costs merely rose with per-person GDP. "Health costs" denotes the additional growth due to the fact that per-beneficiary health costs are growing faster than per-person GDP.

GDP. This is consistent with the underlying nature and structure of these programs. The slow, gradual decline in these programs as a share of GDP is expected to continue in the decades after 2017.

This is why it is not strictly accurate to speak of a *general* "entitlement crisis" rather than to focus on the projected increases in Medicare, Medicaid, and Social Security costs in coming decades, which, as noted, will be driven by rapidly rising health care costs and demographics.

Table 1

CBO's Projection of Growth in Various Parts of the Budget as a Share of GDP, 2007-2017

The "Big Three"	+1.8%
All other Entitlements	-0.3%
Domestic Discretionary Spending	-0.8%

Similarly, domestic discretionary programs as a group have been shrinking as a share of GDP over time and are likely to continue to do so. Moreover, when discretionary programs keep pace with inflation and population growth, they generally maintain their per-person levels of service, even though they are rising more slowly than GDP. It also may be noted that contrary to popular impression, funding for domestic discretionary programs has not risen sharply in recent years; although funding for these programs did rise in the early years of this decade, it now constitutes a slightly *smaller* share of GDP than it did in 2001.

History supports these observations and conclusions. Over the last 30 years, total expenditures for all federal programs other than the "big three" have essentially held constant in real per-capita terms (i.e., after adjustment for inflation and population growth) and have declined as a share of GDP. CBO's ten-year forecast, the nature and structure of these programs, and historical experience all suggest that this trend will continue in the decades ahead. These programs thus are expected to consume a slightly smaller share, rather than a larger share, of the nation's resources in coming decades than they do today.

Tax Policy Choices Will Have a Major Impact on the Long-Term Problem

Tax policy decisions that Congress must make over the next few years will have significant implications for the size of the long-term problem. As explained above, our projections show a fiscal gap of 3.2 percent of GDP. This means that enacting annual revenue increases or program reductions equal to 3.2 percent of GDP would ensure that debt in 2050 was no higher than it is today as a share of the economy. Since allowing recent tax cuts to expire as scheduled — or extending these tax cuts and offsetting their costs — would increase revenues by nearly 2 percent of GDP per year, it would reduce the fiscal gap by three-fifths, shrinking it from 3.2 percent of GDP through 2050 to 1.3 percent. Stated differently, making the recent tax cuts permanent without paying for them would more than double the fiscal gap through 2050, relative to what it would otherwise be. (Measured over a period that extends beyond 2050, allowing the tax cuts to expire would reduce the size of the fiscal problem by a smaller, although still quite substantial, fraction.)

These tax policy decisions will have this large an effect on the fiscal outlook precisely because they will be made soon. Declining to extend the tax cuts, or offsetting the costs of doing so, would quickly reduce deficits by about two percent of GDP and have impacts on debts and interest payments that would compound over time. As a consequence, the downward effect on the deficit would steadily increase with each passing year and ultimately be significantly larger than two percent of GDP. This is an illustration of the basic fact that the sooner that revenue and expenditure

It also should be understood that even with major reforms, it is likely to prove virtually impossible to hold health care expenditures in either the public or private sector to their current levels as a share of the economy. While the U.S. health care system contains significant inefficiencies that raise its costs, the *rate of growth* in health care costs is driven largely by medical advances that tend to improve health and lengthen lifespans but also increase costs. It is inconceivable that Americans will not want to avail themselves of the medical breakthroughs that will occur in the years and decades ahead, even if those breakthroughs entail significant costs. Furthermore, ongoing economic growth will raise incomes in coming decades, and it would not be unreasonable for Americans to elect to invest a substantial share of that increase in securing better health and longer lives.

The challenge therefore is to pursue major reforms that eliminate inefficiencies in the health care system and restrain costs in the system to the greatest extent possible without unduly constraining medical progress. Of course, if, as seems likely, Americans conclude that better health and longer lives merit a somewhat larger share of their income in the future, it will be necessary to pay for these added costs, rather than simply pile up ever-mounting levels of debt. In terms of the federal budget, that means that increases in federal health-care costs as a share of GDP that occur even after health-care reforms have been instituted will need to be financed by increased revenues, reductions in other projected expenditures, or combination of the two.

In sum, solving the nation's long-term budget problems will require that political leaders enact *both* program reductions and revenue increases and, perhaps most difficult of all, substantial, system-wide health-care reforms.

Implications For Congress

These disquieting budget projections underscore the need for policymakers to take action. The remainder of this testimony offers some observations and recommendations regarding the daunting task you face.

1. ***Protective barriers against measures that would make the problem even more severe.*** Two important initial steps are restoration of the Pay As You Go rules on entitlements and taxes and creation of a barrier against use of the reconciliation process for legislation that would increase deficits. Whether on the tax or the entitlement side, it needs to become significantly harder to enact legislation that would dig the hole deeper.

2. Social Security: There is no shortage of options regarding how to close the Social Security shortfall and restore long-term solvency. If this is done without transferring revenues from the general budget (unless such transfers are financed by new general revenues or new reductions in other programs), it will reduce long-term deficits as well.

There are no "free lunches" here. The task is essentially the same as that which the Greenspan Commission confronted in 1983 — to develop an equitable blend of benefit and tax changes that will close the gap. Two of the best discussions of the available options can be found in a book co-authored by my fellow panelist at today's hearing, Bob Reischauer, and Brookings economist Henry Aaron (*Countdown to Reform: The Great Social Security Debate*) and a book co-authored by the newly appointed CBO director Peter Orszag and M.I.T. economist Peter Diamond (*Saving Social Security: A Balanced Approach*).

3. Health Care: This is by far the toughest challenge. Unlike with respect to Social Security, options for how to reduce projected health care costs markedly while still taking advantage of medical breakthroughs that push up costs, and while providing adequate coverage for all Americans, have not been identified.

Some initial steps are available; Congress can modestly reduce Medicare costs by adopting the recommendations of the Medicare Payment Advisory Commission. The fundamental task, however, is reform of the overall U.S. health care system.

There is a "first principle" to system-wide reform: any reform should ensure that health insurance is provided that effectively pools healthy individuals with those who are sicker. In the absence of such pooling, insurance will be inaccessible or unaffordable for Americans with various health conditions.

(This, in fact, is the Achilles' heel of the President's new proposal. That proposal places the current tax treatment of employer-based insurance on the table, a step many analysts welcome. But the plan would lead to the erosion of employer-based coverage — which does pool healthier and sicker workers — and to the shifting of many people who currently have employer-based coverage into the deeply flawed individual health insurance market, which discriminates rather aggressively against those in poor health.[3])

There are a number of possible approaches to health-care reform. Such approaches will need to find ways to reduce inefficiencies in the U.S. health care system and to slow the rate of health-care cost growth while covering all Americans and pooling risk across healthy and sick individuals alike.

Finally, some areas of health care will require additional resources, such as the State Children's Health Insurance Program (SCHIP). The budget baseline for SCHIP is frozen at $5 billion a year. Yet health care costs continue to rise. The actuaries at HHS have estimated that if SCHIP is frozen at the $5 billion a year baseline level, the number of low-income children insured through the program will fall by 1.5 million — or more than one-third — by 2012. Moreover, funds are needed not merely to close this SCHIP shortfall but to reach more of the low-income children who remain uninsured. Some 5.6 million low-income children in our nation remain without health insurance today, a situation not found in any other western industrialized country.

4. Revenues: As this testimony indicates, revenues must be part of the equation. It is inconceivable that Congress will cut key domestic programs as deeply as would be needed to address the long-term fiscal problem without additional revenues. (Doing so also would produce various undesirable effects.)

The argument is sometimes made that one cannot raise taxes above their current levels, or touch any of the 2001 and 2003 tax cuts, because doing so would seriously damage the economy and

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[3] The President's plan would enable states to redirect some resources away from hospitals that provide uncompensated care to the uninsured and to shift those resources to state programs such as "high-risk" pools. Those high-risk pools have not been very effective, however, because they pool sick individuals with even sicker individuals. What is needed are mechanisms that effectively pool the healthy and the sick.

thereby actually reduce revenue collections. The claim also has been made that the recent tax cuts are responsible for the nation's current economic health and, far from costing money, are producing a revenue boon.

Such claims do not stand up under scrutiny. The economy has *always* grown in the recoveries that follow recessions, regardless of whether or not taxes have been cut. Indeed, the current recovery is somewhat weaker than the average post-World War II recovery with respect to an array of key indicators, including overall economic growth, investment growth, job growth, and wage and salary growth. Moreover, the current recovery is not stronger than the recovery of the 1990s was, and that recovery followed two significant tax increases.

Nor has revenue growth been remarkable. Revenues have grown strongly the past two years, but this robust growth essentially represented a rebound from several years of extraordinary revenue declines. Revenues declined in nominal terms for three straight years from 2001-2003, the first time that has occurred since before World War II.

Among the best ways to measure current revenue growth is to examine how revenues have fared over the current business cycle. Such an examination reveals that revenues in 2006 were merely at the same level in real per-capital terms as they had been at the start of the business cycle five years earlier. In contrast, by this point in the average post-World War II business cycle, revenues have risen 10 percent in real per-capita terms.

Finally, most economists believe that large, deficit-financed tax cuts can yield short-term stimulus but can *reduce* growth over the long term, because of the effects of the resulting increases in deficits and debt in soaking up capital that could otherwise be invested. CBO, the Joint Committee on Taxation, the Congressional Research Service, economists at the Federal Reserve, and economists at Brookings have all found that if major tax cuts are deficit financed, long-term economic growth is as or more likely to be reduced than to be increased.[4]

Steps to raise more revenues should, where possible, be taken in conjunction with tax reform, since various ways of raising revenues can have differing economic effects. One first step that Congress could take would be to examine carefully the numerous options presented in an important study the Joint Committee on Taxation issued in January 2005 and the additional options described by the Joint Tax Committee in a follow-up report prepared for the Senate Finance Committee in August 2006.[5] These studies presented numerous recommendations for curbing unintended or unproductive tax breaks and for narrowing the "tax gap." A number of these measures would raise revenues while simplifying the tax code.

[4] See, for example, Alan J. Auerbach, "The Bush Tax Cut and National Saving," National Tax Journal, Volume LV, No. 3, September 2003; and Douglas W. Elmendorf and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," prepared for the National Tax Association's 2002 Spring Symposium; William Gale and Peter Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," Tax Notes, October 18, 2004; Gale and Orszag, "Deficits, Interest Rates, and the User Cost of Capital: A Reconsideration of the Effects of Tax Policy on Investment," Urban Institute-Brookings Institution Tax Policy Center, August 19, 2005; Congressional Budget Office, "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates," December 2005; and Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief," JCX-4-05, March 1, 2005.

[5] Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 27, 2005, and Joint Committee on Taxation, "Additional Options to Improve Tax Compliance," August 3, 2006.

Congress also needs to address the growing problems presented by the Alternative Minimum Tax. Given the daunting fiscal problems the nation faces, Congress needs to find ways to address these problems in a revenue-neutral manner.

- AMT repeal would cost $800 billion over the next ten years (2008-2017), if the 2001 and 2003 tax cuts are not extended, and $1.5 trillion if they are extended, according to estimates by the Urban Institute-Brookings Institution Tax Policy Center. It is more costly than estate tax repeal.

- Continuing the current practice of providing an AMT "patch" each year without covering the costs is becoming increasingly expensive and fiscally imprudent. Continuing on this course will cost $70 billion *a year* by 2010 and more in the years that follow.

Last week, the Tax Policy Center issued a study presenting options for revenue-neutral AMT reform that would protect middle-class taxpayers without swelling deficits and debt. The study merits close consideration.

Finally, Congress should seriously consider freezing tax cuts that are not yet in effect, particularly tax cuts that will exclusively benefit people at the top of the income scale. In particular, two tax cut that President Bush did *not* request, but that were added on top in 2001, are only partially in effect now. These two tax cuts are slated to *triple in size* between now and 2010. Analysis by the Tax Policy Center shows that almost two-thirds of the benefits of these two tax cuts will go to the 0.3 percent of U.S. households with incomes exceeding $1 million a year, a group that the Tax Policy Center says already is receiving average tax cuts of more than $100,000 a year. Some 98 percent of these two tax cuts will go to the 4 percent of households with incomes over $200,000, the Tax Policy Center reports.

If these two tax cuts are held at today's levels rather than permitted to triple in size, about $13 billion would be saved over the next several years. This is about the cost of averting the cuts that would occur in the State Children's Health Insurance Program over the next five years and take 1.5 million low-income children off the program if funding for SCHIP is frozen at the baseline level.

5. A measure to secure savings simultaneously on both the spending and tax sides of the budget: Some measures can both restrain expenditures and enhance revenues. Most experts believe that the Consumer Price Index slightly overstates inflation. To address this overstatement, the Bureau of Labor Statistics has developed an alternative CPI. Most analysts across the political spectrum believe the alternative measure is superior. On average, the alternative measure (sometimes referred to as the "superlative CPI") rises a few tenths of a percentage point more slowly per year than the traditional CPI.

Congress should move to adopt the use of the superlative CPI on both the expenditure and revenue sides of the budget. Such a step likely would be attacked by some as cutting Social Security benefits or raising taxes, but such attacks would be unwarranted. The intention of the Social Security Act and the Internal Revenue Code is to adjust for inflation, not to *over*adjust. This change would meet those intentions.

This change would produce small savings initially. But the savings would grow over time and become significantly larger in the years when the fiscal problems we face will be extremely serious.

6. ***Discretionary programs:*** I have placed this part of the budget last for two reasons. First, I do not have expertise in the defense budget and will not discuss it here. Second, opportunities for substantial savings in non-defense discretionary programs are quite limited.

Non-defense discretionary programs (including international affairs and homeland security) have declined from 5.2 percent of GDP in 1980 to 3.6 percent of GDP today, and they constitute a shrinking portion of the budget. These programs make up 18.1 percent of the budget today. Under CBO's projections, they will constitute 14.5 percent of the budget by 2017.

This is not to say there is no fat anywhere in the discretionary side of the budget. But there also are substantial unmet needs that will require more resources form this part of the budget, and savings in some discretionary programs likely will need to be reinvested in other discretionary areas. Two examples of areas where the resources are needed were cited by the President in his State of the Union address — the need for increased resourced to fight disease and ease poverty and debt in some of the world's poorest countries, and the need for more resources for alternative energy research. Other areas where additional discretionary resources are warranted include IRS enforcement, child care for children in low-income working families, and housing vouchers for low-income families, to name just a few.

* * * * *

That concludes my testimony. I would be happy to address questions the Committee may have.

Table 5
Combined Effect of the 2001-2006 Tax Cuts
Distribution of Federal Tax Change by Cash Income Class, 2010[1]

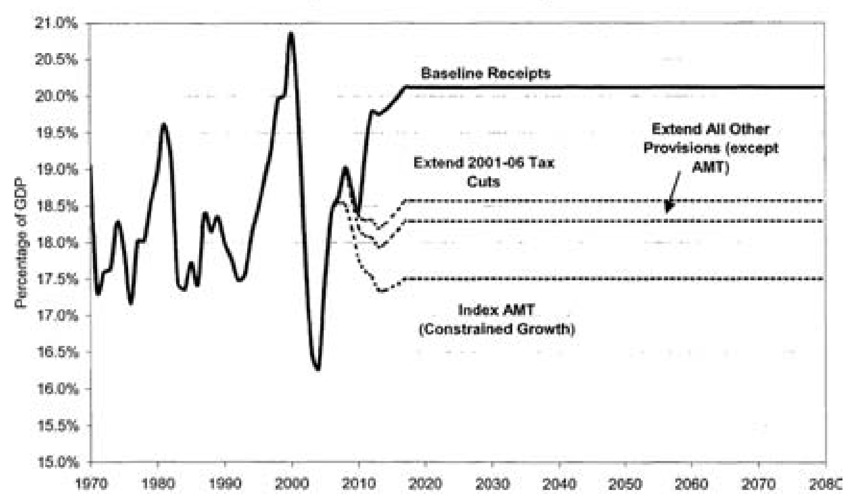
Cash Income Class (thousands of 2006 dollars)[2]	Percent of Tax Units[3]		Percent Change in After-Tax Income[4]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[5]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Less than 10	3.8	0.1	0.1	0.0	-5	-2.0	0.0	0.2	-0.1	4.3
10-20	45.8	0.5	1.2	1.7	-177	-20.0	-0.1	0.7	-1.1	4.3
20-30	73.9	0.3	2.3	4.5	-557	-17.9	-0.2	2.2	-2.1	9.5
30-40	85.1	0.1	2.3	4.8	-785	-13.2	-0.1	5.3	-2.1	13.6
40-50	90.8	0.1	2.2	4.4	-871	-9.7	0.0	4.2	-1.8	16.5
50-75	96.0	0.2	2.3	10.3	-1,212	-8.7	0.1	11.3	-1.8	19.0
75-100	95.9	0.3	2.3	9.1	-1,684	-7.9	0.2	11.0	-1.8	20.8
100-200	92.9	0.1	3.3	18.2	-2,530	-6.7	0.8	26.3	-1.7	23.9
200-500	90.6	0.1	2.6	11.5	-3,886	-6.4	0.6	17.4	-1.8	26.6
500-1,000	98.9	0.0	5.6	9.1	-28,578	-12.8	-0.3	6.1	-3.9	26.5
More than 1,000	99.4	0.0	7.6	26.0	-157,418	-13.9	-0.8	16.5	-4.9	30.4
All	72.3	0.2	3.0	100.0	-1,686	-9.4	0.0	100.0	-2.3	21.8

Baseline Distribution of Income and Federal Taxes
by Cash Income Class, 2010[1]

Cash Income Class (thousands of 2006 dollars)[2]	Tax Units[3]		Average Income (Dollars)	Average Federal Tax Burden (Dollars)	Average After-Tax Income[4] (Dollars)	Average Federal Tax Rate[5]	Share of Pre-Tax Income	Share of Post-Tax Income	Share of Federal Taxes
	Number (thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Less than 10	17,249	11.2	6,020	263	5,756	4.4	0.9	1.1	0.2
10-20	25,257	16.3	16,275	883	15,392	5.4	3.6	4.5	0.9
20-30	21,176	13.7	26,983	3,107	23,876	11.5	5.0	5.6	2.4
30-40	15,863	10.3	37,911	5,940	31,971	15.7	5.2	5.8	3.4
40-50	13,044	8.4	48,808	8,939	39,869	18.3	5.5	6.0	4.2
50-75	22,180	14.3	67,154	13,960	53,194	20.8	13.0	13.1	11.2
75-100	14,059	9.1	94,376	21,345	73,031	22.6	11.5	11.8	10.9
100-200	18,782	12.1	147,048	37,637	109,411	25.6	24.0	23.5	25.6
200-500	5,289	3.4	310,634	88,278	222,356	28.4	14.5	13.1	16.9
500-1,000	831	0.5	738,482	223,945	514,537	30.3	5.3	4.9	6.7
More than 1,000	431	0.3	3,304,623	1,110,653	2,193,970	33.3	12.8	10.2	17.7
All	154,718	100.0	74,322	17,878	56,444	24.1	100.0	100.0	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1)
(1) Calendar year. Baseline is pre-EGTRRA law. Tax cuts include individual income and estate tax provisions in EGTRRA, JCWA, JGTRRA, WFTRA, AJCA, TIPRA, and PPA.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see
http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income

Projected Federal Receipts if Tax Law Remains Constant
(Under several scenarios)



Source: C. Eugene Steuerle, Adam Carasso, and Gillian Reynolds, The Urban Institute, 2007. Authors' calculations based on projections by the Congressional Budget Office, *The Budget and Economic Outlook, FY 2008-17*.

analysts tax facts

from the Tax Policy Center

The True Tax Rates Confronting Families With Children

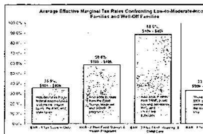
By Adam Carasso and C. Eugene Steuerle

The panoply of U.S. tax and transfer programs often act in concert to penalize low-income families who increase their work effort or marry, by saddling them with higher effective marginal tax rates. Why do those higher tax rates occur? The targeting of benefit programs to groups with less income means that benefits phase out (as if being taxed) as families earn more. The addition of another spouse with earnings often accelerates the loss of benefits that would be faced by a single head of household.

As an example, if family income increases by $1,000, a household might experience a $211 loss in the earned income tax credit, a several-hundred-dollar drop in food stamp benefits, or a drop in Medicaid benefits worth thousands of dollars. In some cases, parents who opt to work more or marry may see little or no additional gain (or actual losses in the case of marriage) in total income as a result. Those program phaseouts, which are often hidden from participating families, combine with statutory federal and state income tax rates to create very high effective marginal tax rates for many moderate-income families.

The chart below compares the average effective marginal tax rates (AMTR) of a low- to middle-income single-parent family with two young children living in Pennsylvania in 2004, with the AMTR of more well-to-do families. The first three bars in the figure focus on the AMTRs of the single-parent family with income (exclusive of program benefits) between $10,000 and $40,000. In the first bar, if we consider only the combined tax rates of federal taxes and tax programs (statutory rates, EITC, child credit, and payroll taxes) and state taxes (statutory rates only), the AMTR is 35.9 percent. However, the effective marginal rate rises appreciably if the family is also enrolled in transfer programs, as shown in bars 2 and 3. For a family enrolled in universal, non-wait-listed programs like Food Stamps, Medicaid, and the State Children's Health Insurance Program (SCHIP), the AMTR would be 58.8 percent. If the family enrolls in additional, wait-listed programs like housing assistance and child care, the AMTR ratchets up to 88.6 percent. The fourth bar, by way of comparison, shows that the AMTR affecting families (lumping one- and two-parent families together) at $80,000 or above is 33.2 percent — lower than that applying to the lower earning families.

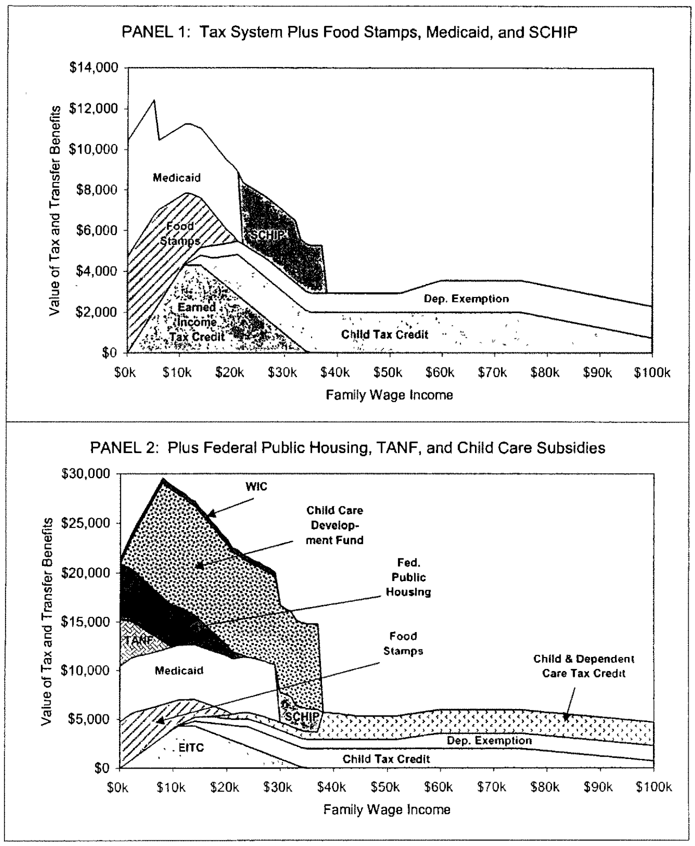
Average Effective Marginal Tax Rates Confronting Low-to-Moderate-Income Families and Well-Off Families



Tax Policy Center
Urban Institute and Brookings Institution

The Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution, provides independent, timely, and accessible analyses of current and emerging tax policy issues for the public, journalists, policymakers, and academic researchers. For more tax facts, see http://www.taxpolicycenter.org/taxfacts.

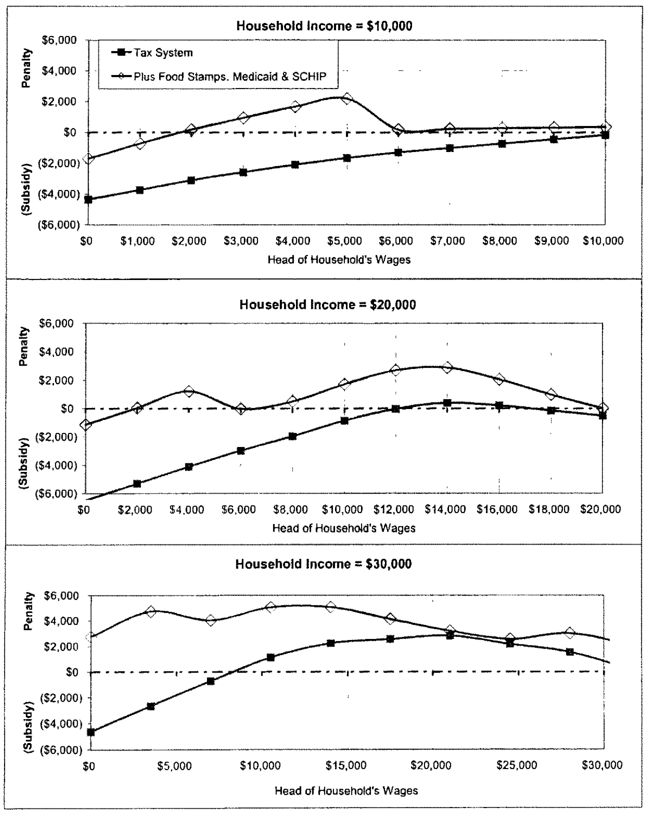
FIGURE 1: Select Tax and Transfer Benefits for a Head of Household with Two Children in Tax Year 2004



Source: Calculations by Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2005. Notes: Child ages are assumed to be 2 and 5. Tax calculations include the alternative minimum tax and assumptions on itemized deductions. Transfer programs apply rules for Pennsylvania, which is the median TANF benefit state. We assume $5,000 maximum annual child care costs. Note that in the second chart, the adults in a family previously on TANF remain eligible for Medicaid up to 185% of poverty (for up to 12 months after leaving TANF).

FIGURE 3: Dollar Amount Of Marriage Penalties And Subsidies In Select Federal Tax And Transfer Programs For A Married Couple With Two Children In Tax Year 2004

(Assumes a single earner marries a head of household with two children who earns 0% to 100% of couple's income)



Note: The "Secondary Earner" was a head of household with two children, prior to mariage. Her earnings range from 0% to 100% of household income in each example. The Primary Earner earns the balance, and was a single filer without children, prior to marriage Marriage penalties and subsidies include the effects of Social Security taxes (both the employer and employee portion) and state income taxes
Source: Calculations by Adam Carasso and C Eugene Steuerle, The Urban Institute, 2005

Chairman CONRAD. Thank you very much, Dr. Greenstein. Thank you for those new numbers that, in many ways, confirm what we have been talking about with the previous witnesses, the Chairman of the Federal Reserve and the head of the General Accounting Office, who both outlined in some detail the really daunting challenges that we face.

Now we will turn to Dr. Reischauer. Thank you. Thanks for being here. And please proceed with your testimony.

STATEMENT OF DR. ROBERT D. REISCHAUER, PRESIDENT, URBAN INSTITUTE

Mr. REISCHAUER. Thank you, Mr. Chairman, and members of the committee. I appreciate the opportunity to appear before you today.

With your permission, I would like to submit my prepared statement for the record and confine my remarks to an elaboration of a couple of points made in that statement.

Chairman CONRAD. We would be happy to take your statement in full.

Mr. REISCHAUER. First, today, through Mr. Greenstein's testimony, and during the committee's recent hearings, you have heard a number of experts present long-run budget projections that show that debt and deficits begin to soar around the third or fourth decade of this century as interest expenses, which are the one component of the budget that truly is uncontrollable, begin to explode.

The fact that the current budget situation appears, at least on the surface, to be rather benign and that three-plus decades is a long time out, may lead some to believe that we need not rush to make the policy adjustments required to make the fiscal situation sustainable. This, as you have already heard, would be a big mistake, for it is inconceivable that the paths portrayed in these long-run projections will play out as presented.

As the fine print that accompanies most of these projections notes on, these estimates do not take into account the feedback effects of deficits on the economy which will act to depress economic growth significantly and that will further exacerbated the fiscal situation.

Nor do these projections examine the ramifications of the growing ownership by foreigners of dollar denominated assets on the well-being of U.S. citizens. The profits, rents, dividends, interest and capital gains associated with those assets will be paid to foreigners, raising their, not our, standard of living. In other words, a growing fraction of the fruits of whatever economic growth we do enjoy will be captured by foreigners because they will be the ones who own the capital.

For these reasons, it is highly likely that policymakers will be forced to begin the adjustment process far sooner than a superficial reading of these long-term budget projections imply. If we do not begin to take steps to live within our means soon, we run an increasing risk that some unpredictable crisis will dictate both the timing and the pace of the unavoidable adjustment process.

This does not mean that we have to swallow all of our medicine at once, that we have to sit down today to work out an adjustment of 3.2 percent of GDP, which is the Center on Budget and Policy Priorities' new estimate of the gap. But it does mean that we need to show a good-faith effort that we are willing to begin this process.

In addition to some modest tax and spending restraints enacted immediately, we should adopt policies that may go into effect many years from now but will indicate the direction that we are headed in.

Recall that in 1983 we adopted changes to the normal retirement age in the Social Security program that did not affect beneficiaries until the year 2000, 17 years later. But it gave an indication that we were aware of a problem and we were going to do something about it.

In addition, I would urge you to consider enacting mechanisms that provide for automatic adjustments when and if things go off path. These might include mechanisms that shave the automatic indexation both in our tax code and in our entitlement programs. They would be a form of failsafe so that those who are skeptical about Congress's ability to address problems in a timely manner would know that behind the scenes automatic trigger devices might dampen the damage.

Second, it is clear, as you have heard from other witnesses, that the primary cause of the long-run fiscal problem is the inexorable growth in per beneficiary health spending which significantly exceeds the growth in per capita GDP. If, through some miracle, we were able to hold per capita health spending in Government programs to the level of per capita GDP growth, it would not be a heavy lift to get the rest of our fiscal house in order.

But unfortunately, there are no miracles on the shelf. The problem of rapidly growing health costs is not confined to U.S. Government programs, as Mr. Greenstein has pointed out. The same pressures affect both the private sector and foreign countries. What is different is that the private sector and foreign countries have mechanisms that force the parties to consider the tradeoffs between improved health care and other priorities.

For example, in our employer-provided health care system, employers and workers must choose between receiving their compensation in the form of better health insurance on the one hand or in the form of higher cash wages and more generous non-health benefits on the other. In countries that budget explicitly for their national health systems, tradeoffs are made between higher taxes, charges and premiums on the one hand and new and more costly health benefits on the other.

With open-ended entitlement programs and a seemingly unlimited capacity to borrow, we have only very weak constraints on our major Government health programs.

In my opinion, we will probably need to fundamentally restructure the Nation's health care delivery system and the mechanisms used to finance it if we hope to moderate cost growth without compromising the quality of care.

This is a daunting challenge because it affects not just public programs but rather the entire health system of our country. As Mr. Greenstein has noted, and David Walker has said many times, we are not about to create in this country a separate delivery system for the elderly, disabled and poor, one that is different from that that workers and their dependents enjoy. Nor are we about to tolerate one level of care for Medicare and Medicaid beneficiaries and another level of care for those enrolled in the employer-sponsored system.

Over the long run, I think we are going to have to move away from the current fragmented, uncoordinated delivery system, a system in which individuals buy their care a la carte using insurance that is heavily subsidized by the Federal Government. We are going to have to move toward more coordinated mechanisms for delivering care and are going to have to begin to define what basic, essential health care is and provide access to that care to the entire population.

This obviously is an area that goes well beyond the jurisdiction of this committee and I close by suggesting that should the will be there to move in this direction, it will probably involve some initial investment in infrastructure and information technology to facilitate such a transition.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Reischauer follows:]

Defining our Long-Term Fiscal Challenges

Statement of Robert D. Reischauer*

Committee on the Budget
United States Senate
January 30, 2007

Mr. Chairman and Members of the Committee, I appreciate this opportunity to discuss with you some of the challenges posed by the long-term fiscal outlook. This statement

- **summarizes the current budget situation and the outlook,**
- **explores the roots of the long-run imbalance and some related solutions, and**
- **discusses some aspects of the unavoidable adjustment process.**

<u>The recent fiscal situation and the intermediate outlook.</u>

The recent fiscal situation and the intermediate term budget outlook appear relatively benign. The fiscal 2006 deficit was 1.9 percent of GDP, lower than deficits in all but seven of the last 30 fiscal years. Moreover, in each of the past three years, the actual deficit has come in significantly below the levels that either the Office of Management and Budget or the Congressional Budget Office (CBO) predicted just nine months before the end of the fiscal year. These overly pessimistic estimates have given some policy makers hope that the future will turn out to be better than the experts predict and that watchful waiting may be the appropriate course.

These optimists will also take solace in the latest budget projections. Last week, CBO projected that, under baseline assumptions, today's modest deficits will be replaced

* President of the Urban Institute. The views expressed in this statement should not be attributed to the Urban Institute, its sponsors, staff, or trustees.

by a small surplus in 2012 that will grow slowly through the remainder of the fiscal 2008-17 projection period. Even when CBO's projections are unshackled from the unrealistic constraints of the baseline methodology, the fiscal picture does not appear unduly threatening over the next decade. If the baseline were modified to include more realistic estimates for military and other discretionary spending, extension of the tax cuts and indexation of the AMT, the resulting deficits would remain close to the average of the past three decades and under 3 percent of GDP. Another ray of hope for the budget optimists is the President's announcement that his fiscal 2008 budget proposal will show the budget balanced by 2012 while making permanent the tax cuts enacted after 2000.

But the relatively benign intermediate-run budget outlook should be no cause for complacency. As the Congressional Budget Office, the General Accountability Office, the Chairman of the Federal Reserve Board, the Office of Management and Budget and many objective experts have concluded, long-run projections "show clearly that the budget is on an unsustainable path."1. If current tax and spending policies are not altered significantly, deficits and debt will gradually grow to unprecedented and unsustainable levels.

Unless American households and businesses increase their saving very dramatically, the continued viability of the nation's economy will depend increasingly on the willingness of foreigners to accumulate ever-larger holdings of dollar denominated assets. While their appetite for such assets might be sustained for a period, the nation will be becoming increasingly dependent on others whose economic priorities and political interests may not coincide with our own. Our ability to conduct economic and foreign policies that are in the

1 . Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007, Analytical Perspectives*, page 196.

nation's best interests could be limited by this dependence on foreign capital.

When, as it surely will, the foreign appetite for dollar denominated assets begins to abate, interest rates will begin to rise, capital for productive investment will begin to dry up, and the rise in living standards, which is such an important underpinning of the nation's political stability, will begin to slow.

And so, significant budget adjustments are unavoidable. The question all of us must answer is, "Do we want have control over the timing, pace and composition of these adjustments or do we want to leave such decisions to others or to unpredictable events?" While it is possible that the adjustment process will occur gradually over a number of years, history is replete with examples of overreacting markets or unexpected crises forcing sharp policy changes of this sort. Almost always, such changes occur when other circumstances—like an economic downturn or political turbulence in the world—make them all the more painful.

<u>The Roots of the Unsustainable Budget Outlook</u>

Notwithstanding the rhetoric about "bloated" discretionary spending (both non-defense and defense), "runaway" welfare-related entitlement programs, and "irresponsible" tax cuts, none of these caricatures of reality helps us understand either current deficits or the unsustainable budget outlook. At 7.8 percent of GDP, discretionary spending is a bit above what is was between 1995 and 2003 but well below the levels common from the start of the Cold War through tbe mid-1990s. Of more importance, most long run budget projections assume that discretionary spending (both non-defense and defense) will grow more slowly than the economy over the next half century leaving discretionary spending as a percent of GDP by 2050 well below even the levels achieved in

the 1990s. Similarly, entitlement programs that don't benefit mainly the elderly and disabled have not been breaking the bank recently nor are they expected to do so over the coming decades. In the long run projections, they too represent a smaller fraction of GDP in the future than do today. Even though the many tax cuts enacted since 2000 have reduced revenues substantially below the amounts needed to pay for the goods and services government provides, at 18.4 % of GDP, revenues were about at their historic average relative to the economy in fiscal 2006. Most long run projections predict that, even if the recent tax cuts are extended, revenues will grow a bit faster than the economy over the long haul as real incomes continue to rise.

Clearly, we must look elsewhere for the roots of the severe future budget imbalance predicted for the future. And those roots are to be found in the retirement-related entitlement programs—Social Security, Medicare, and Medicaid. Together, spending on these three programs will grow to over 20% of GDP by the middle of the century, up from 8.0% of GDP in fiscal 2006 and 6.6% in 1990. It would be reasonable to assume that mainly demography—the retirement of the baby boomers—is driving this dramatic increase. But that would be wrong. Only about one-quarter of the increase in spending above GDP growth is related to the burgeoning numbers of program beneficiaries. The bulk of the increase is explained by the expectation that, as in the past, per beneficiary health expenditures will rise a good deal faster than per capita GDP.

Averaged over the past few decades, per capita spending on health care has grown about 2.5 percentage points faster than per capita GDP. This has been true for government-financed health care programs and for plans financed by employers and workers which should not be surprising considering that workers, their dependents, and

Medicare and Medicaid beneficiaries all use the same providers and access the same delivery systems. Doctors, hospitals, nursing homes and other health care professionals do not practice one type of medicine for those in government-financed programs and another for those who are enrolled in privately-financed plans.

There is little reason to expect that we will see any marked slowdown in per capita health care spending absent significant restructuring of our health care delivery system or radical changes in the way health care is financed. While some of the increase experienced over the past four decades is attributable to ever more generous insurance coverage, most is related to technological advances that have provided more effective and less invasive treatments for diseases and disabling conditions. If anything we should expect an even more rapid increase in the capabilities and cost of medical care as the genomic era progresses and nano technologies are more fully employed.

The search for solutions.

Rapidly rising health care costs are, of course, not just a problem facing government. Employers are struggling with the ballooning cost of the health benefits many provide their workers and those workers are reeling under exploding premiums, higher cost sharing, and depressed wage growth.

To the extent that solutions are sought for soaring Medicare and Medicaid costs, they can not be found solely within the public sector programs. Durable solutions will probably require significant restructuring of the nation's health care delivery system and the mechanisms used to finance it. While we build up the resolve to undertake such a restructuring, a number of more incremental approaches are being pursued. But compared to the challenge, these efforts are relatively small in scale, disorganized, and

uncoordinated. While many hold some promise for improving the quality of care, their impacts on both the level of costs and the growth of cost are far more uncertain. For example, pay for performance schemes usually focus on improving clinical quality and, as such, are likely to push up costs as care improves. If pay for performance plans could also reward efficiency, as the IOM has recommended, some cost savings may develop but it is extremely difficult to measure and reward efficiency across episodes of care in our fragmented and uncoordinated delivery system.

Some hint of the extent to which improved efficiency might lead to reduced costs can be garnered from the work of Elliot Fisher and his colleagues at Dartmouth. They have found that, after adjusting for input price differences and underlying health risks, per beneficiary Medicare costs vary almost two to one across the nation's hospital referral districts. And health outcomes, if anything, seem to be negatively correlated with higher spending and service use. Unfortunately, these differences are deeply imbedded in the practice patterns of each region's medical professionals and the expectations of each area's patients. And both are reinforced by the region's institutional infrastructure and its desire not just to survive, but also to thrive. In short, it seems that all medicine, like all politics, is local and it will take much work and many years to change that situation.

One important ingredient needed to convince medical professionals and patients that more is not always better is increased, high quality information about which interventions work best for which types of patient under what circumstances. Studies of comparative effectiveness and cost effectiveness are essential. Such studies are a public good and it makes no sense to have individual insurance carriers, professional associations, research organizations and academic health centers all dabbling duplicatively in this arena.

A national effort, coordinated if not funded by the federal government, is called for.

It is doubtful that even the most radical restructuring of the nation's health care system could slow the growth of health related spending sufficiently to match the growth of the economy. Nor is it clear that this would be a desirable objective. New, often costly, medical technologies bring obvious benefits that all societies should want more of especially as their incomes increase. In the public sector, taxes will have to be raised or other public services scaled back to accommodate these desires. In the private sector, increases in cash wages and no-health fringe benefits will have to be slowed. The challenge we face is determine how to balance our desire for improved health against our other priorities. We can not have it all and ask our children and grandchildren to pick up the tab.

The Adjustment Process

The budget adjustments that are required to achieve some reasonable fiscal target—such as keeping public debt from growing faster than the economy—are so daunting that it is tempting to procrastinate. But the longer policy makers wait to act, the more wrenching the adjustments will have to be, the greater tbe risk that external forces will dictate the process, and the fewer will be the options available for sharing the unavoidable sacrifice broadly. For example, if better-off elderly are going to be asked to bear a bit more of the burden of financing their Medicare benefits, it would be unfair and politically impossible to decide to impose that change after a majority of the baby boomers had already retired and relatively ineffectual to impose such a policy only prospectively on those yet to enroll in the program.

Notwithstanding the past precedents of enacting large omnibus balance budget bills,

it is important to realize that there is no requirement that all of the medicine needed for the cure be swallowed at once. Certainly, partial solutions are better than none at all and many solutions could—in fact, should—be phased-in over a number of years or adopted on a piecemeal basis. It is particularly wise to phase-in policy changes that cut entitlement benefits for the elderly, disabled or other vulnerable populations. For example, if policy makers decide to index Social Security's normal retirement age to increased longevity or accelerate the increase from 66 to 67 in the normal retirement age that, under current law, will take place for those turning 62 between 2017 and 2022, the decision should be made immediately to provide those affected sufficient time adjust their saving and work plans.

Piecemeal changes may be acceptable when there is considerable uncertainty about the programmatic or budgetary impacts of a policy change. Excessive change can prove to be counter productive because it can generate a backlash that repeals too much of the initial adjustment. This occurred with the Medicare cuts made by the Balanced Budget Act of 1997. Weighing against any reluctance to do too much is the reality that it is far harder to enact than to scale back after the fact a deficit reducing policy.

In the past, it has proven acceptable to make the decision to profoundly change policy long before the change is to be implemented. Although the decision to raise Social Security's normal retirement age was made in 1983, it was not until some 17 years later in 2000 that the first beneficiary received a reduced benefit payment. Similar steps should be considered anew.

When considering ways to make the fiscal situation more manageable, Congress should also consider adopting trigger mechanism that would automatically shave spending or boost revenues by small amounts when the fiscal train began to leave the tracks. The

indexing provisions of the tax code and entitlement programs offer obvious places to insert such adjustments. Often many small nibbles spread over time are often more acceptable than one large bite. Households, communities, businesses and sub-national units of government need time to adjust.

As the Chinese proverb states, "A journey of a thousand miles begins with a single step" and, notwithstanding the relatively benign fiscal situation that we seem to be enjoying today, that first step is overdue.

Chairman CONRAD. Thank you, Dr. Reischauer.

Dr. Steuerle, welcome. Good to have you back before the committee.

STATEMENT OF DR. EUGENE STEUERLE, SENIOR FELLOW, URBAN INSTITUTE

Mr. STEUERLE. It is good to be here. I would like to express my appreciation to all the members of the committee for their bipartisan effort to tackle this very important problem.

One of the reasons I enjoy being before this committee is because it has a tradition along those lines, to work together on those issues.

I would like to begin by undertaking an imaginary exercise with you. Suppose that during the presidency of William Howard Taft, Congress had enacted laws that would predetermine all spending and tax subsidies for today and throughout the 21st century. As economic growth led to higher Government revenues, these legislators would have continued to prescribe, now from six feet under, how to divvy up the spoils. Their ingrained policy wheels would run over future elected officials and voters and prevent any new priorities members wanted to enact. Each political party would hope to see the other party forced to do damage control in the budget but view it as political suicide to do anything substantial itself.

Ludicrous scenario? Not really. In recent decades, we have essentially wound just such a straitjacket around ourselves. Never before has the law predetermined so much of our future spending and tax subsidy priorities. Yet it makes no more sense to commit economic resources that far into the future today than it would be to decide where to station troops into the next millennium.

In my view, only major systemic reform can restore a normal democratic process. We need budget slack—that is wiggle room for new policy between future Government revenues and current spending commitments.

I want to be very clear about this. Deficit reduction is not enough to get us there, because you would still end up having committed all those future revenues.

In the remainder of my testimony, I would like to highlight some extremely important consequences of our current budgetary situation, consequences I think that are of concern to members of both parties.

First, larger shares of our budget spent on retirement benefits leaves an increasingly smaller share to finance activities more likely to promote productivity such as nursing advice for pregnant mothers, early education for the very young, and after school activities for older children.

Second, our system of elderly support has morphed into a middle-aged retirement system. A couple retiring at age 62 today can expect to get benefits for 26 years. When Social Security was young, the average worker retired at about age 68. To retire for an equivalent number of years today in Social Security, a person would retire at about age 74. I have a few graphs in my testimony that are being shown which try to summarize some of this information.

Third, most economic projections include a slower rate of growth of the labor force, partly because so many people now retire in late middle age. Keep in mind that for any given tax rate supporting old age programs you may decide to enact or compromise upon, a structure of significantly higher benefits can be maintained if people work longer. Why is that? Because if they work longer, there are more revenues.

Fourth, almost every year a smaller share of Social Security benefits goes to the oldest and most vulnerable in terms of health needs and capacity for working. If progressivity is defined by how well the vulnerable are served, the system is becoming less progressive every year.

Fifth, lifetime benefits in Social Security and Medicare for an average couple have now risen from about $250,000 in 1960—these are real dollars—to over $750,000 today and are scheduled be over $1.2 million for a couple retiring in about 25 years. We cannot keep adding benefits for this part of the population without shrinking services for the rest of the population.

Sixth, building eternal growth into permanent programs affects taxes as well as spending. Two examples provided in my testimony are for Roth IRAs and for tax subsidies for the purchase of health insurance. These policies are badly designed not simply from a budget standpoint (because they give away revenues or spend revenues before we even determine the needs of the day), but also because the additional amount spent on them may actually decrease saving and decrease the number of people with health insurance. The President has or attempted to address this latter issue in part with his recent proposal on dealing with the tax exclusion for health insurance.

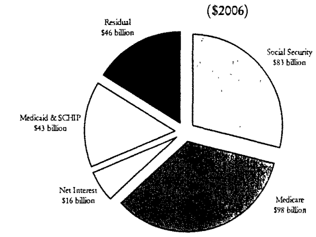
Seventh, within a quarter century, close to one-third of the adult population is scheduled to be on Social Security. If we add other individuals in society who are dependent upon other assistance programs, we are approaching the day when about one-half of the population will be significantly dependent upon Government for its support. A Government that treats everyone as needy, treats no one as needy.

Eighth, the squeeze on children and working families is being felt now. It is not awaiting for some day in the future. Under reasonable projections within a very short period of time, all revenues will be eaten up by Social Security, Medicare, Medicaid, defense, and interest on the debt with nothing left for anything else. Your charts, Mr. Chairman, as well as those of Dr. Greenstein, also support that fact.

Ninth, the continually declining share of the budget for discretionary spending means continually declining Congressional control over the budget. My own suggestion here to deal with this issue, in part, is to change the presentation of the budget at the time when the President's budget comes out. It requires no legislation. It only requires the Congressional Budget Office and the Office of Management and Budget to present budgetary changes first in a way that combines automatic and discretionary changes.

One example I give in my testimony, and that you can see on the monitors next to you, is that according to Congressional Budget Office revenue projections, revenues will be increased in 2010 by about $286 billion over and above what they are today. These are real revenues, but almost all of those revenues have already been pre-committed to growth in Social Security, Medicaid, Medicare and interest on the debt.

Figure 7: How Future Increases in Revenue Have Already Been Spent
2010 versus 2006
($2006)



$286 billion = increase in revenues in 2010 relative to 2006

Note: if Other Mandatory, Discretionary Non-Defense, and Defense outlays-- the major components of the residual -- maintain their same share of GDP by 2010 it will cost $37, $59, and $62 billion respectively, for a total of $157 billion to fund increases in these outlays.

Source: C. Eugene Steuerle and Gillian Reynoods, The Urban Institutue, 2007 . Based on data from CBO, Budget and Economic Outlook 2008-2017, various tables

Consequence 10: A Government Dedicated to Baby Boomers-and No One Else.

The baby boomer generation—my generation—once talked about what type of government we could help create to best serve society. As now scheduled, our legacy is to bequeath a government whose almost sole purpose is to finance our own consumption in retirement. Not only haven't we come close to paying for the government we are scheduled to receive, but we plan to eat away at the rest of government that would serve our children and grandchildren.

CONCLUSION

By abandoning control over the budget to automatic, rather than discretionary, budget choices, we have put in place a system where politicians are forced to compete by giving away the future. Projected deficits are merely one symptom of this modern legislative push.

The budgetary consequences I've outlined follow from neither progressive nor conservative principles. They must be addressed on grounds of both fairness and efficiency if government is to serve all the people, if it is to be flexible enough to meet the needs of the times, if it is to be nimble in addressing new needs or emergencies, and if it is to restore democracy to the people.

9

This type of presentation shows you—and allows you to show the public—the lack of control you have over how to allocate these additional revenues. A more informative presentation requires showing not just changes from current law but total changes from what we are doing today, thus, we combine together changes in current law and changes from terms of what we are spending today into a single presentation.

My final consequence is a bit personal. As a member of the babyboom generation, I grew up with a cohort who believed we were trying to do something about improving what Government can do. And yet now, as currently scheduled, our legacy is to bequeath a Government whose almost sole purpose is to finance our own consumption in retirement.

In sum, by abandoning control over the budget, we have put in place a system where politicians are forced to compete by giving away the future. Projected deficits are merely a symptom, they are merely a symptom, of this modern legislative push.

The budgetary consequences I have outlined follow from neither progressive nor conservative principles. They must be addressed on grounds of both fairness and efficiency if Government is to serve all of the people, if it is to be nimble in addressing new needs and emergencies, and if it is to restore democracy to the people.

Thank you.

[The prepared statement of Mr. Steuerle follows:]

Defining Our Long-Term Fiscal Challenges

Testimony of C. Eugene Steuerle

Senior Fellow, The Urban Institute

Before the Senate Budget Committee

January 30, 2007

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

Defining Our Long-Term Fiscal Challenges

When the Athenians finally wanted not to give to society but for society to give to them, when the freedom they wished for most was freedom from responsibility, then Athens ceased to be free... **Edward Gibbon**

Thank you Mr. Chairman and members of the committee for the opportunity to testify on defining our long-term fiscal challenges. I'd like to begin by undertaking an imaginary exercise with you.

Suppose that during William Howard Taft's presidency, Congress had enacted laws that would predetermine all spending and tax subsidies throughout the 21st century. As economic growth led to higher government revenues, those legislators continued to prescribe—from six feet under—how to divvy the spoils. Their ingrained policy wheels would run over future elected officials and voters and prevent any new priorities unless past promises were rescinded.

Unable to see their way out of this logjam, our next generation of elected officials might try—albeit, unsuccessfully—to waddle back and forth between promising even more relative to what could be delivered and enacting only symbolic policies that accomplish little. Each political party would hope to see the other forced into damage control on the budget, but view it as political suicide to do anything substantial itself.

Ludicrous scenario? Not really. In recent decades, we have essentially wound just such a straightjacket policy around ourselves. The main culprits have been in the broad areas of retirement, health, and taxation—essentially those parts of the budget where members of Congress, many now dead or retired, succeeded in enacting permanent policies that not only skirted annual decision making, but, worse still, received ever-larger shares of national income and of government revenues. At the same time, of course, these policymakers indirectly required future generations to pay the tab or to raise the resources to meet those promises.

Eternal Commitments of Program Growth for An Unknown Future

Make no mistake about it. This particular type of fiscal crisis is unique in our nation's history. Never before has the law pre-ordained so much of our future spending patterns. Never before have dead and retired policymakers so dominated officials elected today. And never before has so much of policy bypassed the traditional set of breaks applied through normal democratic decision-making.

When the nation dramatically increased its financial obligations in the past—through wars, the costly Louisiana Purchase, in depressions—the budgetary commitments were temporary, no matter how large the price tag. The permanence of our newer obligations—for retirement security, health care, and many tax subsidies—is different and inappropriate. It makes no more sense to commit future economic resources than it would be to decide today where to station troops until the next millennium.

Perhaps the most costly part of current budgetary policy is its political repercussions. It takes democracy away from voters. It treats future generations like adolescents who cannot be trusted to do the right thing. It leads to weak leadership and stymies the creativity of elected officials. Left alone, it leaves the current Congress with almost no control over its own budget.

There is no way out of this labyrinth by merely constructing it further, simply building more walls through new programs and tax subsidies without attention to what has already been constructed. Only major systemic reform can restore a normal democratic process. Each generation must regain the right to decide spending and tax priorities based on the nation's current needs, not on past anticipation. We need budget slack—that is, wiggle room for new policy—between *future* government revenues and *current* spending commitments for the future.

The deficit is not an adequate focus for solving this fiscal mess, since the deficit is only a symptom. Even if Congress were brave enough to enact laws to project exactly zero deficits in the future, there would still be no future slack. After all, a reform looking only to deficits would not create any positive slack. If the economy quintupled in size, as it did last century, and revenues also quintupled (or quadrupled or sextupled, depending upon how political power evolved), we still would have laws in place that prescribed policy for decades and centuries to come. Again, I note, this lack of slack is unprecedented.

Seeing Opportunity

Fixing the budget is easy to achieve economically. Slack in budgets is the normal course for households, businesses, and—until very modern history—government. Households and businesses seldom sign contracts today for what they are going to buy decades in the future. Federal budget slack is being eaten away by promises on both spending and taxes that, taken as a whole, are now impossible to fulfill. Restoring democratic choice is almost entirely constrained by politics, not economics—although failure to deal with the politics can have severe economic consequences.

One way to see opportunity in this fiscal mess is simply to realize that turning the budget upside down means turning it right-side up. That is, we must recognize that the budget priorities (now set automatically, often by moldy legislation) are themselves upside down relative to our true societal problems. We are scheduled to spend ever-rising amounts as a response, not to problems, but to advances in well-being—in particular, gains in life spans and improvements in health care. Where we have problems as a society—children unattended by adults, rising numbers of families without health insurance, failures of our educational system, areas with too high crime rates, and homeland security—we now claim we can't do much because of growth in other commitments.

We should also recognize opportunity in people in their late 50s, 60s, and 70s, who have now become the largest underutilized pool of human resources in the economy. They represent for the first half of the 21st century what women did to the labor force for the last half of the 20th century. I believe that coming years will see substantial demand for this talent, and it is mainly our inherited institutions, public and private, that are blocking us from making full use of these valuable people.

In the remainder of my testimony, I would like to highlight ten extremely important consequences of our current budgetary situation—consequences that arise from pre-committing so much of our future revenues.

Consequence 1: A Budget Increasingly Oriented Against Growth

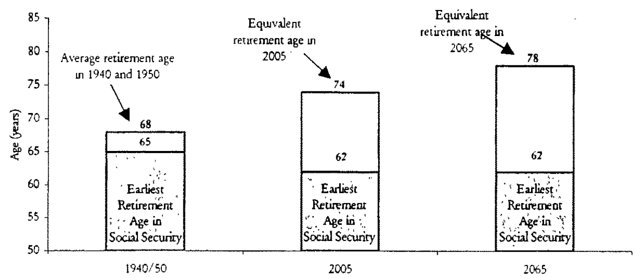
Larger shares of our budget spent on retirement benefits leaves an increasingly smaller share of the revenue pie available to finance activities more likely to promote productivity—nursing advice for pregnant mothers, early education for the very young, and additional training, mentors, and after-school activities for older children. Over time, the net result of a continually greater share of the budget for consumption likely will mean a smaller share for investment in human capital, which, in turn, likely leads to lower rates of overall economic growth and less economic gains for future generations.

Consequence 2: An Increasingly Middle-Aged Retirement System

Our system of elderly support has morphed into a middle-age retirement system. People already spend close to one-third of their adult lives in retirement. The average Social Security annuity for a man retiring at 62 in 2006 lasts 19 years; for a woman, 22 years, and for the longer living of a couple, at least 26 years. The numbers are even higher for those with above-average lifetime earnings.

When Social Security was young—for instance, in 1940 and 1950—the average worker retired at about age 68. To retire for an equivalent number of years on Social Security, a person would retire at age 74 today and age 78 in another 60 years (figure 1). Perhaps the most important budgetary decision we have made over the very long-term in Social Security has been to provide more and more years of retirement support.

Figure 1: Program Retirement Age--Indexed for Life Expectancy



Source: C Eugene Steuerle and Adam Carasso, The Urban Institute, 2007. Based on data from the Social Security Administration, Birth Cohort Tables, 2007. Note: these figures are based on male life expectancies as reported by the 2006 Trustee's Report

Consequence 3: A Scheduled Drop in Labor Force and Economic Growth

Beginning in 2008, most economic projections include a slower growth rate of the labor force (see figure 2) and, consequently, of the gross national product—partly because so many people in late middle-age are scheduled to drop out of the labor force. Inadequate attention is being paid to these labor force issues and to their budgetary consequences.

Figure 2. Labor Force Projections

Annual Growth Rate			
1990-2000	2000-2010	2010-2020	2020-2030
1.33%	0.95%	0.63%	0.39%

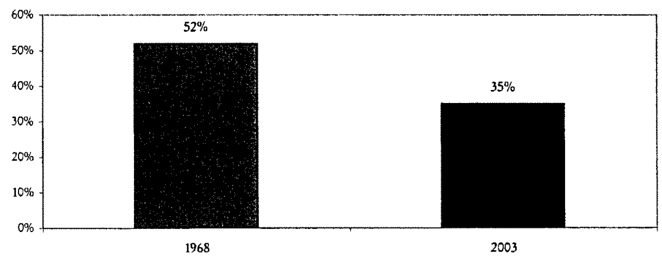
Source. C Eugene Steuerle and Gillian Reynolds, The Urban Institute, 2007. Based on data from Mitra Toossi, Bureau of Labor Statistics, A New Look at Long-Term Labor Force Projections to 2050, Table 4.

Thus, when looking at old-age programs, the increase in beneficiary payouts is only half the story. A decline in revenue growth also occurs. For any given tax rate supporting old-age programs, a structure of significantly higher benefits can be maintained if people work longer, partly because there are more revenues available.

Consequence 4: Less Attention to the Truly Old and Most Vulnerable

Almost every year a smaller share of Social Security benefits goes to the oldest and most vulnerable in terms of health needs and incapacity for working (figure 3). If progressivity is defined by how well the vulnerable are served, the system is becoming less progressive every year. Social Security also discriminates against single heads of household, who are often more vulnerable than many spouses who work less, raise less children, pay less taxes, yet still receive higher benefits.

Figure 3: Proportion of Men's Social Security Benefits Going to Men With Less Than 10 Years Remaining Life Expectancy

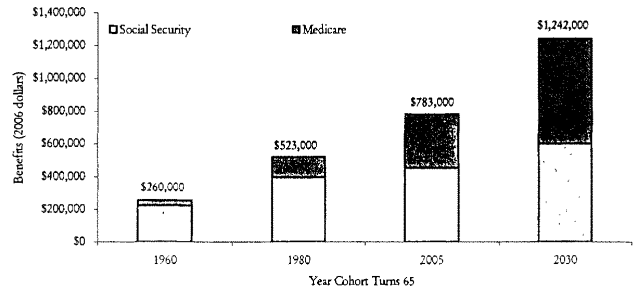


Source. C. Eugene Steuerle, Adam Carasso, and Gillian Reynolds, The Urban Institute, 2007.
Based on data from the Social Security Administration's 2005 Annual Statistical Supplement, Table 5A.1.1

Consequence 5: Program Millionaires

In today's dollars, lifetime benefits—Social Security and Medicare—for an average-income couple have risen from about $260,000 in 1960 to $783,000 today to over $1.2 million for those retiring in about 25 years (figure 4). We cannot keep adding benefits for this part of the population without shrinking services provided to other parts of the population.

Figure 4: Lifetime Social Security and Medicare Benefits*
-- Average-Wage, Two-Earner Couple ($37.8K each) --



Source: Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2006.
* Expected rather than realized benefits. Notes. The "average" hypothetical wage profiles are taken from the Social Security Administration. Lifetime amounts, rounded to the nearest thousand, are discounted to present value at age 65 using a 2 percent real interest rate and adjusted for mortality after age 65. Projections are based on intermediate assumptions of the 2006 OASDI and HI/SMI Trustees Reports.

Consequence 6: A Broken Tax System

Building eternal growth into permanent programs affects taxes as well as spending. Here are two examples of how tax subsidies are made to grow in ways similar to many expenditure entitlements.

First, Roth IRAs and Roth 401(k) plans have been designed to give many taxpayers *negative* or zero tax rates on income from deposits. These taxpayers can reap very substantial, compounding, tax benefits for decades to come—throughout their lives and those of their children. The 5- and 10-year budget windows fail to show the consequence of this very long-term budget choice.

Second, the employee exclusion for employer-provided health benefits is scheduled to grow continually faster than the economy. The additional amounts spent on this exclusion—over and above some base amount—likely lead to an increase in the number of uninsured because they add to spending on health, which, in turn, add to the cost of insurance. The higher cost insurance drives out some employers from offering insurance and drives away some consumers from buying it.

Consequence 7: Less Ability to Address Poverty and Its Causes

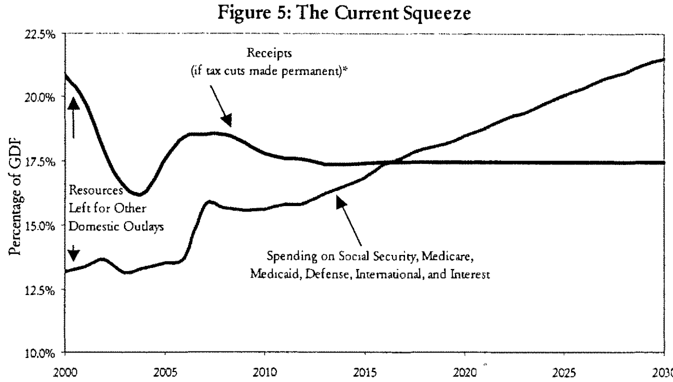
Within a quarter century, close to one-third of the adult population is scheduled to be on Social Security. Adding in other assistance programs, one-half of the adult population will depend on the government for significant amounts of their support. A government that treats everyone as needy treats no one as needy.

Within Social Security itself, most of the additional expenditures each year go toward raising benefits for everyone and financing early retirement, rather than reducing poverty among the elderly.

Consequence 8: A Squeeze on Children and Working Families

The squeeze on the budget is now, as baby boomers prepare to move out of the labor force. Assume merely that Social Security, Medicare, and Medicaid continue on automatic pilot, that interest on the debt is paid, and that, as a percent of GDP, existing levels of revenues are allowed to rise only moderately and defense expenditures are able to be reduced only moderately. Then in a very short period of time there is no revenues left for anything else (figure 5). Children and working families are especially likely to feel the pinch.

Figure 5: The Current Squeeze

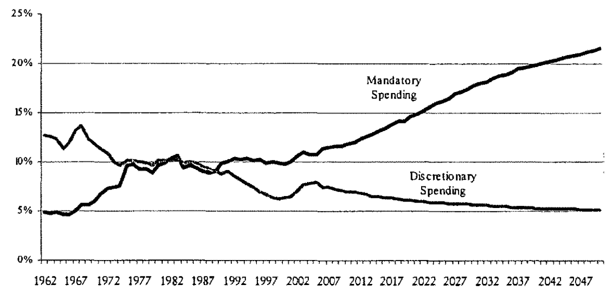


Source C Eugene Steuerle, Adam Carasso, and Gillian Reynolds, The Urban Institute, 2007 Authors' calculations based on data from CBO Budget Outlook (January 2007) and OASDI and HI-SMI Trustees Reports (2006)
*Assumes extension of 2001 and 2003 tax cuts and of expiring tax provisions and a permanent fix to the alternative minimum tax
^ Assumes a moderate drop in defense and international spending as a percent of GDP

Consequence 9: Less Ability to Meet the Needs of the Nation as They Arise

Every year Congress exercises less control over its own budget. We have taken from ourselves the freedom to allocate government resources by relying mainly on past decisions and formulas to determine how today's expenditures should grow. This is reflected in part by the declining share for discretionary spending , which has fallen from over two-thirds of the federal budget in the 1960s to about one-third today (figure 6).

Figure 6: Mandatory and Discretionary Spending as a Percent of GDP 1962-2050



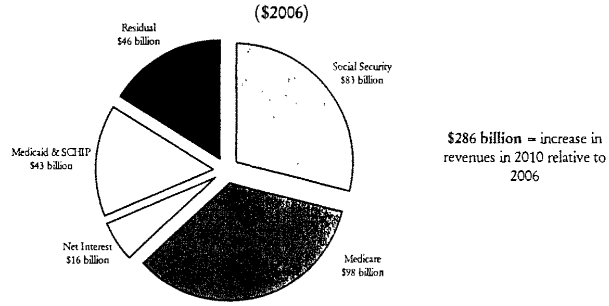
Source C Eugene Steuerle and Gillian Reynolds, The Urban Institute, 2007 Based on data from the Federal Budget Historical Tables FY2007, various tables and CBO The Long Term Budget Outlook, 2005

I would like to make a recommendation here. I believe that there are better ways for budget authorities to clarify to the nation just how our priorities are being set in the budget. It requires no legislation. It only requires the Congressional Budget Office and the Office of Management and Budget to present budgetary changes *first* in a way that combines automatic and discretionary changes. An especially useful time to do this would be when the president offers his budget to the nation. Presenting changes only from "current law" to some proposed law, by way of contrast, is insufficient and often misleading. For instance, it suggests that reducing health cost growth from 8 to 7 percent is a "cut," while raising real spending on education or work subsidies from 0 to 1 percent is an "increase."

Figure 7 shows one way to combine automatic and discretionary changes relative to what I will call current practice. Here I show that according to the Congressional Budget Office revenues (in 2006$) are projected in 2010 to be $286 billion higher than in 2006, but that almost all of that increase is already committed to growth in Social Security, Medicare, Medicaid, and interest on the debt (the last of which is likely underestimated because of very strong assumptions about defense, tax increases, and what happens to national debt as many other programs are cut back under "current law.").[1]

[1] When the president's budget comes out, CBO and/or OMB would show, first, the total change from "current practice" (essentially current law in the previous year) to proposed law, then break out how much of that change was due merely from changes built into mandatory programs on both the expenditure and tax side of the budget from year to year and how much from additional proposed changes. These changes could also be shown as a percent of GDP, not merely in terms of changes in real taxes and spending. Other options are possible, but the main goal would be to present first all changes together.

Figure 7: How Future Increases in Revenue Have Already Been Spent
2010 versus 2006
($2006)



Note: if Other Mandatory, Discretionary Non-Defense, and Defense outlays-- the major components of the residual -- maintain their same share of GDP by 2010 it will cost **$37, $59, and $62 billion** respectively, for a **total of $157 billion** to fund increases in these outlays.

Source: C. Eugene Steuerle and Gillian Reynoods, The Urban Institutue, 2007 . Based on data from CBO, Budget and Economic Outlook 2008-2017, various tables

Consequence 10: A Government Dedicated to Baby Boomers-and No One Else.

The baby boomer generation—my generation—once talked about what type of government we could help create to best serve society. As now scheduled, our legacy is to bequeath a government whose almost sole purpose is to finance our own consumption in retirement. Not only haven't we come close to paying for the government we are scheduled to receive, but we plan to eat away at the rest of government that would serve our children and grandchildren.

CONCLUSION

By abandoning control over the budget to automatic, rather than discretionary, budget choices, we have put in place a system where politicians are forced to compete by giving away the future. Projected deficits are merely one symptom of this modern legislative push.

The budgetary consequences I've outlined follow from neither progressive nor conservative principles. They must be addressed on grounds of both fairness and efficiency if government is to serve all the people, if it is to be flexible enough to meet the needs of the times, if it is to be nimble in addressing new needs or emergencies, and if it is to restore democracy to the people.

Chairman CONRAD. Thank you. Thanks to the entire panel.

Let us get right to it, if we could. We have been searching for things that we could do on this committee in this budget resolution and, as you perhaps know, Senator Gregg and I have been searching for a process that would compel at least the presentation of a plan to our colleagues in the Congress later this year of a long-term plan to address the fiscal imbalances that we confront.

So we are interested in both the short term and the long term.

Mr. Greenstein, you indicated as one of your suggestions, that we deal with the CPI, that we have a more accurate adjustment to the CPI than the current formula permits. How much difference, have you done any calculation of how much difference that would make over time on both the spending and the revenue side?

Mr. GREENSTEIN. I believe that an estimate was done by the Brookings Institution. This is not a recommendation that is peculiar to me. Many budget analysts across the political spectrum have made it. It is included in a Brookings book, Restoring Fiscal Sanity, that came out a couple of years ago. I am not sure my memory is going to be right here.

My recollection is that by the 10th year it might save something like $30 billion or $35 billion.

The point is not the 10-year savings. It is when you go further out. I am not going to trust my memory for the farther out figures, but we can look into them and get back to you and the committee and give you our best figures.

I want to make one caveat about my own recommendation here, and that is over time this would be an important change, moving to what is sometimes called the superlative CPI. What would be a mistake, I think, would be to move to it without firewalls that ensure that the savings are going for deficit reduction and, of course, for closing the Social Security long-term imbalance.

If you were to do this and you simply took the savings and used them to finance program increases and tax cuts, you would have gained nothing and you would have foregone an important instrument for the future.

So I think you should make this change with the CPI but I think you should not do it until you are combining it with firewalls that make sure that money is dedicated to long-term deficit reduction and is not used to finance expansions or tax cuts now.

Chairman CONRAD. Well, you make a very good point. The question is how you construct firewalls that last around here. Sometimes we have constructed them and they last for a few years, but as soon as they start to achieve real savings, there is a tremendous impetus around here to go after it for additional spending or for additional tax cuts.

Unfortunately, in the last several years, we have been doing both and so keep digging the hole deeper.

Mr. GREENSTEIN. I do think in 1990 and 1993 there were major deficit reduction legislation and the savings helped. Part of that was because of the pay-as-you-go rules and the construction of the pay-as-you-go scorecard so that you did not get to put the savings from those bills on the scorecard and spend them. And it worked. So I think we ought to—

Chairman CONRAD. It really did. It certainly helped. All of these moves to discipline Congressional action on both the spending and the revenue side contribute. But if there is no will, there is no way. And we go back to the 1990's. That held for a period of time and ultimately it broke down.

Mr. GREENSTEIN. One other very quick point. I also think it would be helpful to change the rules so that reconciliation can only be used for legislation that reduces deficits. Whether someone wants to expand the prescription drug benefit, reduce taxes, or whatever, you should not be able to fast track it with 51 votes. It should be harder to do that. That, to me, is another one of these firewalls that would be helpful.

Chairman CONRAD. On both the spending and the revenue side?

Mr. GREENSTEIN. Yes.

Chairman CONRAD. Dr. Reischauer, I want to turn to you, if I could. You indicated in your testimony that there has been work done at Dartmouth that shows that per beneficiary Medicare costs vary two to one across the Nation's hospital districts. And health outcomes are negatively correlated with the higher spending.

Can you tell us a little more about that? As I understand what you are saying here, is that this Dartmouth study indicates we could have one part of the country where they are spending twice as much on Medicare beneficiaries as in another part of the country and actually getting worse health care outcomes? Is that the conclusion of their work?

Mr. REISCHAUER. The studies done by Elliott Fisher and a number of other individuals, have shown wide variation in per beneficiary Medicare spending after adjusting for differences in input prices and the underlying health conditions of the Medicare population. Spending as the extremes are about two to one apart.

There is certainly no significant positive relationship between spending or service utilization, which is what this is about, and health outcomes. To the extent there is any correlation, it is a weak negative correlation. What health economists have found is that there are wide differences across the country in the practice patterns of physicians and on the expectations of patients.

And so for the same condition you will see patients in Miami going to the doctor, let us say 15 times a year, and those in Minneapolis going seven times a year. You will see across individual hospitals within one metropolitan area even wider variation in the number of consults from specialists for a particular condition.

So health care, in a sense, is not a science. It is an art. And we have not spent a sufficient deal of resources or time trying to figure out what is the optimal amount of health care, what are the right procedures, what are the right treatments to give an individual in these kinds of circumstances to maximize health outcomes.

And so a problem arises when we discover that in Miami they use twice as many resources for a congestive heart failure case as they use for a congestive heart failure case in Minneapolis. What do we do? We cannot move the Miami population to Minneapolis. We have a very difficult time, changing the pattern of practice of the physicians in the high utilization area.

We have to think of incentives that can bring this wide variation more toward some optimal level which will save money without jeopardizing the quality of health care.

Chairman CONRAD. All right, good points.

Senator ALLARD.

Senator ALLARD. You have all mentioned, to some degree, I think in your testimony, this concept of shared sacrifice. So how do we do this? Do we do something like an across-the-board cut, impacting all programs proportionally the same? How do we prioritize our fiscal discipline, I guess is the question that I am asking? What criteria do we decide to say well, maybe this program is more important than another? Maybe it has more cuts. How do we decide what program is maybe performing and which is not performing? And do we set criteria along those lines? I would like to hear your comments.

Mr. STEUERLE. Mr. Allard, if I may speak first, I think the most important thing this committee could do with respect to teaching Congress would be to try to somehow or another get a refocus on the long-term even before the short-term. I realize that is not the normal budget process but, as everyone on this committee knows, the game that is played in the budget process is to do what you can within a budget rule for 3 years, 5 years, 10 years or whatever, and then not worry about the period beyond that. So many recent enactments that have cut the deficit in the short run have actually added to the long-term deficit.

We all know the games that are played and we know why they are played. It is because the budget rules right now orient themselves toward the short-term. And so we constantly attempt only to get the short-term in order.

And while I actually agree with many of Dr. Greenstein's proposals, a lot of them get us to the short term but they leave us on this path of continually rising expenditures as a percent of GDP—rising expenditures that are not oriented toward our most current needs. If you really think about where we are increasing spending, where we are talking about having a budget crisis, these are in areas where good things are happening to us. We are living longer, we are getting better health care. And we are saying we cannot control that retirement and health budget, and, therefore, we do not have money to spend on homeland security or children's education or kids that are out of school on the street when they should not be.

So where we have problems, we say we do not have money, and where we really having good things happening to us, we are spending more.

I think the budget process has to focus on the long-term. Now how would I do that? How would I think about changing the process?

One thing I would do is to ask perhaps CBO or the General Accounting Office, but probably the Congressional Budget Office, to identify every part of the budget where there is automatic growth. And I would include of all the tax provisions, all of the tax subsidies as well, not just direct expenditure. Where is this automatic growth preempting you, as a Congress, from making discretionary decisions? Then use that information to see if you cannot come to some agreement on how to constrain that automatic growth.

Now controlling some of the growth, as in the case of health care, is much, much tougher than others. Some cases, like Social Security, are easier to identify some ways to gain control, although there would be the political dynamic of how to decide what to do. But I think you have to start there. If you do not start with the automatic growth and the long-term, I do not think we will ever, ever get this system in order.

Then you have to address an additional budget rule: are you going to allow any new enactments to spend money way into the future, make commitments for the future, for which the resources are not provided? It seems to me you have to move toward some sort of rule that deals with that issue, as well.

I am not suggesting all this is easy. I think there has been a 30-year process of both political parties figuring out more and more ways to spend away the future because it was not in the budget window. That was not the case in the 1960's or earlier. When discretionary spending was level, revenues would grow with the economy, and you always moved into a surplus when you went into the future.

We have moved to a world now where each party continually tries to spend more and more for the future, take more and more control for the future, because they are afraid of what the other party is going to do.

That is why it takes a compromise between the two parties to say neither is going to spend the future. We are going to let the voters 4 years and 8 years hence start deciding what to do. And so you limit what can be done in the future. If there is growth in programs, it is capped after 5 years and you have to re-vote whether there would be new growth after that period, whether it is wage indexing and Social Security, whether it is the open-ended nature of health benefit programs, whether it is a program like Roth IRAs and Roth 401(k)'s that spend out in the future.

It seems to me the trick is to identify all of those automatically growing parts of the budget and to try to figure out some way to reach an agreement on dealing with them.

Mr. GREENSTEIN. A few problems. Some of the suggestions I made at the end of my testimony were merely intended to be first steps. Ultimately, as Gene says and as Bob has said, we have to do a much heavier lift.

I am not a fan of across-the-board cuts. I think they are a bit of an abdication of policymakers' responsibilities to make the tough choices. There are some areas in the budget where we are going to need some additional resources. The President, for example, talked in his State of the Union, about global AIDS, Millennial Challenge Fund, alternative energy research. Everything in the budget is not equal. And we have to go and make the appropriate choices, rather than just saying everything gets cut X percent, which will be inappropriate for some programs and may too small a reduction for others.

This suggests having a high premium on efficacy. In some areas we need more information and evaluation of what is working and what is not. And that includes looking at efficacy both on the spending side and on the tax side. We have, I forget the figure, something like $800 billion a year in tax expenditures in the budget and some of them are not performing as intended.

I think another criterion that should be put into the mix is the fact that due essentially to trends in the private economy and global pressures, we have had a several decade trend toward increasing inequality in this country. And it would be unfortunate to deal with the budget problems in a way that exacerbated the trend toward increasing inequality.

To kind to put it in a phrase, in the mid-1980's at one point, David Stockman—then Ronald Reagan's budget director, made a statement that I think sums up a principle. He said when you need to deal with the deficit, you should go after weak claims not weak clients. The hard task is identifying which are the weak claims. Often the weak claims have the strongest clients defending them. And reaching bipartisan agreement to pare back the weak claims, whether they be on the expenditure or on the revenue and tax expenditure sides of the budget.

Mr. REISCHAUER. Let me comment on two extreme approaches. One would be the technocratic approach where experts would measure the effectiveness of every Federal program and the ability of various revenue sources to generate additional revenue by doing the least harm to the economy. And we would use that information to cut spending and increase revenues. And the objection to that, besides the fact that we do not have that kind of information, quite simply would be that, the reason we do things depends on much more than the effectiveness with which we can do them. Some things are very important. We know that our policies are not particularly effective but we have to do something to address these issues. Where you come out is, of course, where the Congress has come out with respect to the distribution of spending and tax sources in the budget each year.

So then you go to the other extreme which is that if current problems reflect what our priorities are why don't we just shave everything by X percent or raise all taxes by Y percent because that would reflect our relative weighing of priorities.

We know that is not the case either because of the inertia or the embedded strength of existing programs, that if somehow we could wipe the slate of Federal programs clean and start anew, we would probably end up with quite a different set of spending programs.

So this is a terribly difficult kind of problem to be faced with because neither of these extremes is either possible or appropriate. I guess that is why we elect a Congress to grapple with this really insoluble set of decisions.

Chairman CONRAD. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

First of all, I want to thank for a very thoughtful and critically important panel. Thank you to each of you.

I did want to start by commenting, if I can use the Chairman's charts, one of your illustrious charts, to just emphasize that when we are looking at the numbers that you showed us, the cost of extending the tax cuts are more than the combined costs of Social Security and Medicare. I think this is incredibly important. I know that just on Social Security alone that if we were to say 30 percent of the tax cuts will not be extended instead of 100 percent, you could fully close the gap of Social Security alone.

I think this is a very, very important chart and I appreciate the comments related to all of that when we talk about how do we get where we need to go.

On health care, I also very much appreciate, Dr. Reischauer and Mr. Greenstein, both of you talking about the fact that as it relates to health care it is not just Medicare, is this not just Medicaid. It is the health care system, that we need to fundamentally restructure the health care system.

Mr. Chairman, I would just make the point that this very much is about jobs, as well. I had a chance—I was on a town hall meeting in Detroit with the big three automakers, a major town hall last night, where it was very interesting. We know that about $1,500 per vehicle is health care costs. But we had a gentleman from the Canadian UAW who said that their costs are $200 per vehicle.

In fact, we have employers, manufacturers, that are literally going 5 minutes across the bridge into Canada to set up shop now and build facilities because of health care. The wages are the same, it is the same bargaining units. Everything is the same but health care. This is about jobs, as well as about our economy.

Last week there was an article in the New York Times business section where the president of the Business Roundtable made the following statement, which I thought was very significant: health care costs are the single largest cost pressure that employers face, far exceeding energy, labor, materials, or even litigation.

So it is not only something that we have to tackle but the business community is desperately asking us to tackle this, as it relates to our ability to compete in a global economy.

There is really something wrong when we look at the fact that the average industrialized country spends less—we are spending twice as much in GDP as the average industrialized country for our health care system, but we have close to 50 million people with no health insurance. It just does not add up.

So I very much appreciate your having this panel. And while I believe very strongly that we have to fundamentally restructure the health care system, and that we actually save money doing it. I believe that. I believe we have done this hodgepodge kind of effort that has actually increased costs rather than decreased costs.

But I would like to ask a couple of questions that relate to something that, as we do that, which is a tough thing to do and we have to do it in a bipartisan way to fundamentally restructure things, there are costs savings that we have not mentioned today. I wanted to just mention two and ask for any comments from the panel.

First of all, health information technology. Olympia Snowe, Senator Snowe and I have introduced legislation to accelerate the use of that both through tax incentives for the private sector, as well as support for nonprofits. We have heard numbers anywhere from $70 billion a year in savings to $100 billion from the President's own IT expert, Dr. Braylor, to $300 billion from the RAND Corporation, just focusing on e-prescribing alone.

Those are huge numbers, huge numbers for us. I am wondering if any of you would have a comment on that, both in terms of saving lives. I know in my home State of Michigan that has really been aggressive on this, we have increased quality, we have created more information for people to compare, as the President talks about transparency and comparing prices and so on. And we also see the beginning of savings in dollars.

And then the other relates to the prescription drug front. We know that the average retail price of a brand-name prescription drug was $102 back in 2005 and the average retail price of a generic was $30. Senator Lott and I have legislation to close three loopholes that brand-name companies are using to stop generics from going on the market.

Those are two shorter term but very significant ways to save large amounts of dollars, and I wondered if any of the panel would like to speak to that?

Mr. STEUERLE. Mrs. Stabenow, if I could just address the first issue. I am on the National Committee on Vital and Health Statistics, whose job it has been over the years to try to promote the very thing you are talking about, health information technology. We strongly believe if we could move more to a world of electronic prescribing of drugs, and electronic transmission of information, we could provide enormous protection to people—for instance, those who are moved, such as after a hurricane, or those who do not get all the information on their drugs, or who get duplicate tests. We think there is enormous efficiencies that will come about from health information technology.

The one thing we do not know is whether, on net, that will reduce costs. This is one of those areas in health care where we attempt to improve efficiency; it is an effort we should make. But it could also lead to an increase in demand for services as people determine that there are more needs that they have, that their drug tests need to be improved, and so on.

And so the answer to your question on the cost saving is tentative. The answer on efficiency improvement is not. I think most people agree, we should be moving in this direction.

That gets us back to the issue that I think Dr. Reischauer has raised, which is that you still need, at some point, to decide how you are going to try to cap or limit the automatic growth in the system independently of these improvements and efficiencies.

My own calculations now show that with Government subsidies—Medicare, Medicaid, other health programs and tax subsidies—you are now spending $11,000 per household. That is total health care costs per household now are $19,000 per household. Total health spending in the United States divided by the number of households is $19,000. Government is now providing $11,000 of that total.

In the next 4 years you are scheduled under projections to raise government spending to $13,000. You are going to spend $2,000 more over the next 4 years. And yet you have no control over how you are spending that $2,000.

So you still have to get at this issue of how are you going to try to manage and control the money you spend—even at the same time that you are identifying what you want to achieve with these efficiency improvements. You do not want to achieve cost saving in a way that case would cut back on technology improvement as a way of saving money, which would be the very area where you are actually trying to improve health care.

Mr. REISCHAUER. I think you have pointed to two very important areas. With respect to health information technology, as Dr. Steuerle has pointed out, I think there is a general consensus that aggressive application of such technology will lead to significant improvements in health care quality but that the jury is still out with respect to overall how much might be saved.

It is clear that if we want to move into a new world, a transformed delivery system, one in which there is more coordinated care, more accountability through pay for performance and mechanisms like that, one in which individuals are active in the market more than is the case now in the selection of providers and services, that cannot be done without a much more expansive information technology base than we have now. So in a way it is essential to move forward in structural reform to have better health information technology.

Just abstracting from all of that, of course we will save duplicative tests and things like that, which will save relatively small amounts of money probably over time because many of these duplicative tests were taken 6 months ago and really, you are now the attending physician, do you really want to trust that one rather than get a new one?

With respect to prescription drugs, I think you are right to suggest that there have been some abuse of the patent system and effort by some pharma members to extend the life of their patents and restrict the entry of generic drugs and the Congress should act and the Administration should act to end those abuses.

We have seen, over the past decade, a very significant movement of the population toward generic scripts and there is more to go.

Chairman CONRAD. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman Greenspan, when he was the head of the Federal Reserve and I was a lowly member of the House Budget Committee at the time, about 10 or 12 years ago I believe it was, made the suggestion about the CPI and using the new improved version, whatever you call it.

The Congress, in their wisdom or lack of will, has not been able to get past the results of using the new CPI because of the resulting lowering of certain benefits to a great number of constituents. For instance, those collecting Social Security would not get as large of increase each year if the CPI were adjusted as you have proposed.

So if you can somehow convince the Congress that it is a healthy thing to do long-term, I am with you 100 percent. But I do not know how many members of this committee have the will to use the new improved CPI because less benefits will pay to more people.

Mr. Greenstein, you mentioned entitlement spending and I want to get to that because the CBO baseline spending projections for January 2007 mandatory spending is $1.455 trillion, and 82 percent of that is in the big three, Medicare, Medicaid, and Social Security. If we project that out 2008 to 2017, $19.937 trillion, of which 86 percent are the big three.

So you mention the fact that mandatory spending in other areas were being reduced. It is a very minute 14 percent if we look at it long-term. And what is ballooning the mandatory spending is the big three, if you look at $19.937 trillion over 2008 to 2017.

Now our budgeting rules appear not to be equal when you look at the current baseline budgeting. Mandatory spending programs set up under the law are assumed in the baseline to be extended but tax provisions that are set to expire are assumed, under the baseline, to indeed expire. The effect of this is that extension of tax provisions are subject to budget enforcement and extensions of mandatory spending programs are not.

Do you think it makes any sense to treat spending and tax cuts differently?

Mr. GREENSTEIN. Several parts to your question.

Let me just say, before answering, I want to express my excitement on being here. As a young kid, growing up in Philadelphia, in the 1950's, I watched every pitch on TV of your perfect game, and went running around my living room cheering when you threw that last pitch.

Senator BUNNING. So did I.

[Laughter.]

Mr. GREENSTEIN. Let me start with the CPI. One piece of good news is that since Greenspan issued that report, the Bureau of Labor Statistics has made a number of changes administratively. And actually, the majority of the distortions that his commission talked about have been corrected.

However, there is one key distortion that cannot be corrected in the regular CPI, that is why they developed—BLS, the Bureau of Labor Statistics—the alternative CPI I mentioned, which I recommend Congress adopt.

You raise the point of how could you get it adopted politically? My thought is the following. I think if one simply moved a piece of legislation to move Social Security indexing of the tax code and the like to the alternative CPI, as you say, it would fail. However, I think if this were part of a larger bipartisan budget agreement where you restored long-term Social Security and made substantial progress on the long-term deficit, and this were a piece of it, and one showed that this was part of how one restored long-term solvency and protected the economy and the budget for the long-term, then as part of a larger architecture I would hope that it would be more possible to move.

I think a lot of us also need to do education to explain to people that this should not be regarded as either a cut in Social Security benefits or an increase in taxes because the intention of the Social Security Act and the Internal Revenue Code is to adjust for inflation accurately, not to over-adjust.

On your second point about entitlements in the big three, I do not think we are disagreeing. What I was urging is some more precision in language. I think sometimes when people hear the general term "entitlement crisis", they may presume that unemployment insurance, the school lunch program, that everything is going through the roof. Whereas as we have been doing here today, and as you suggested, we really need to focus on the big three. They are the drivers. And then the factors that are driving the big three, particularly the health care costs.

With regard to the baseline, I would respectfully disagree. I do think that when one looks at it carefully—

Senator BUNNING. What are you disagreeing with? I asked for your opinion.

Mr. GREENSTEIN. I disagree with the conclusion that there is inequity in the treatment of taxes and entitlements in the baseline for the following reason. It is true that if a tax cut is set to expire, the baseline does not assume its continuation. But it is also true, let us take the 2003 tax cut law as an example, that when the capital gains and dividend tax cut was enacted to run through, I believe it was 2008, no cost was scored for 2009, 2010, 2011, 2012 and thereafter.

If there is an entitlement program or expansion and the committee of jurisdiction says well, we are going to let it expire after 3 years in order to avoid being charged with costs from years of four through 10, it does not work. They get charged by CBO with costs for all 10 years.

So the key I think, and maybe one could look at making some adjustments, but the key is that whether it is an entitlement or a tax, you have to make sure you get scored for a cost in every year in that budget window. The current treatment actually does do that. If you want to change the rules, you need to be very careful, I think, to not have a transition where, whether it is entitlements or taxes, you have years in which an increase does not get scored at all.

So again, with regard to the 2001 and 2003 tax cuts, again the 2003 is a good example, they could have been made permanent but then they would have been scored every year in the five and 10-year windows, rather than only scored for the years until they expire.

Senator BUNNING. Thank you.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

I want to thank you for the continuing series of hearings that we have been having to lay out the Nation's fiscal picture and its health, or lack thereof, and I appreciate the panels you have brought together. I appreciate the testimony of this panel.

Last week the testimony from the CBO Director appears to be a rosy fiscal picture for the short-term but it is almost certainly a false hope for the deep and long-standing issues we face in the long-term. That is some of what I would like to go to.

Let me start off with Mr. Greenstein. To me a budget is about values, both as to how we raise revenues for it, as well as to how we spend it. Americans have budgets in their own lives, even if they do not think of it in that context. It is how they derive their income and how they spend their income for education, keeping a home for their family, for health care, tithing to their church or synagogue as an expression of their personal values. I think the national budget is an expression of our collective values.

In that context, I think many of us questioned the President's claim that the budget can be balanced by 2012, given the vast number of anticipated but excluded costs that, when included, provide a very different picture.

I believe, I think it is widely believed, the President's budget is expected to also allow for the current tax cuts to be made permanent. Can you talk a little bit about what type of cuts to domestic programs might be necessary if that is the reality?

I know, for instance last year the Center pointed out in a report that the President's budget proposal for this year proposed some rather massive cuts to key domestic programs, including $52 billion for education, $24 billion in health care programs over a 5-year period, $183 billion over 5 years total. Obviously there is a lot of values of people who depend upon those for their very existence.

Can you give us a sense of what we might be facing if, in fact, the President comes forth with a budget that keeps the tax cuts permanent and the consequences that may flow from that?

Mr. GREENSTEIN. The first comment, I would urge you to look carefully at the budget when it comes out and see whether the balance in 2012 is in reality or just on paper. From the reports we have so far, it sounds like the budget will extend relief from the Alternative Minimum Tax just for 1 year and thereby effectively assume that by 2012 about 40 million Americans are under the AMT, which we know will not be allowed to occur. If you continue the current AMT patch without paying for it, in my testimony I recommended AMT reform be done in a revenue neutral manner. But if the current course is continued, and it is extended without paying for it, that is $95 billion in 2012 that will not appear in the budget.

We are also unclear whether, with regard to Iraq, Afghanistan and the war on terrorism, whether there will be anything in there for 2012.

But the point you are particularly referring to is that I think it is likely that the budget will continue the practice of the last few budgets of having significant reductions proposed in a number of domestic discretionary programs in the coming year, this would be 2008, with specific proposals, but then much larger reductions in domestic discretionary as a whole in years after 2008 without any of the specifics being there, thereby assuming reductions in the domestic discretionary programs that ought to be viewed either as very unrealistic and unlikely ever to occur or, if they really did occur, would have some pretty significant effects in a range of areas. It could be education, could be child care, could be a whole array of issues.

I also think we are talking here this morning, I think the panel in general, mostly about the big three programs, health care and revenues. I think it is an illustration of the fact that as you look, whether it is to 2012 or to the long-term picture, in my view there are not large savings to be had on the domestic discretionary side of the budget. It has declined as a share of GDP over time. It is actually, by 2007, with the CR that was filed last night, going to be a little below where it was in 2001 as a share of GDP, which contrary to the popular impression that it has exploded.

And while there are areas one can and should get savings in domestic discretionary, there are a number of areas in domestic discretionary or some areas that are going to require additional resources, whether they be in the area of global disease and poverty, alternative energy research, child care, which has been frozen for a number of years and were we are actually reducing the number of children in low-income working families who get child care each year.

If we do things that help deal with global warming but raise some costs to consumers, we are going to do need to look at the low-income energy assistance program. So I think you are right that the budget is a reflection of values and it ought to be looked at in that context.

One last comment. The Urban Institute Brookings Tax Policy Center, which I think Gene is a Co-director of, their estimates are that if the tax cuts are extended, or maybe it is even in 2010 the last year you can take this out, that the average tax cut for people with incomes over $1 million a year will exceed $150,000 per household per year.

I think there are some value questions about having tax cuts of that magnitude and then cutting programs, including some effective programs, for the less fortunate and struggling families on the grounds that the budget requires us to do it. It is why I think the suggestion is being made here that all parts of the budget be put on the table. And it is kind of why I like that David Stockman phrase about let us look at weak claims, not at weak clients.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

I, too, appreciate your holding these hearings and giving us the opportunity to dig into these long-term issues. I particularly think health reform and tax reform are key to getting on top of these long-term challenges.

Let me start with you if I might, Mr. Reischauer. You have talked persuasively about the issue of health care and health care costs in terms of our long-term picture. It seems to me that it is simply impossible to fix health care unless you say you are going to cover everybody for the essentials. Otherwise we will constantly have cost shifting from the people who have no coverage to people who do have coverage and folks in emergency rooms pick up their bills and the like.

Do you share that view that to fixed health care you have to say you are going to cover everybody?

Mr. REISCHAUER. Senator, I do. I think it is essential that when we consider alternatives for restructuring the health care system that those alternatives encompass the entire population. It need not be that everybody has guaranteed access to the same generous level of benefits. I think we need to, as a society, begin to define what we regard as the basic health care package that no American should be without and ensure that everyone has the financial wherewithal to purchase or be provided that level of insurance.

Senator WYDEN. Thank you. And I think that is an important part of bringing Democrats and Republicans together, in terms of fixing health care.

One other question with respect to the tax code and health, and perhaps I will direct this to you, Mr. Greenstein. I think you can have a debate about how exactly you should go about doing this. But it is indisputable that the tax code on health is regressive. If you are a highflying CEO, you can write off the cost of getting a designer smile on your taxes. However, if you are a hard-working gal at the local hardware store, you probably do not get much of anything out of the tax code.

Do you agree that—and this is not about the details of how you do it—but that fixing the tax code and particularly its regressivity, is a part of sorting out what we need to do to fix health care down the road?

Mr. GREENSTEIN. Yes, I do not think there is much disagreement that the current tax treatment of health care is regressive and looking at that would be part of overall health care system reform.

I do think when we look at it, we need to look not only at the dimension of progressivity/regressivity. We need to be very careful to look at the dimension of healthier people versus sicker people.

So we have a tax treatment now that supports an employer-based system that has warts. It also has the merit of pooling healthier and sicker people. I think the President's plan commendably raises the issue of the tax treatment of employer-based coverage, but I think it then makes the mistake of doing it in a way that would accelerate the unraveling of employer-based coverage and put people into the individual market which, as you know, is deeply flawed now and does not really work for people with serious health conditions or who are sicker.

So we need to look at both a more progressive approach. But in doing so, I think almost the first principle is that we have to make sure we have adequate pooling mechanism that pools the healthy and the sick together, rather than fragmenting them.

Senator WYDEN. I think that is a thoughtful point and I tried to include that a couple of different ways in my Healthy Americans Act. Mr. Reischauer and I have talked about that as well, you have to make sure that there is some risk adjustment process to deal with it.

Let me ask a quick question for Mr. Steuerle, who has always been one of my heroes on the tax reform debate. My sense is that we still have sound thinking from 1986, and that if we say we are going to clear out a lot of the clutter, all of those breaks, we can have progressivity and still drive down rates. Do you share that view? And how does that fit into a sensible approach for our economy in the future?

Mr. STEUERLE. Senator, like you, I strongly believe that base broadening is preferable to rate increases. And I think that conclusion is true whether you are looking at it from a conservative or a liberal view point, that this type of tradeoff provides a more efficient tax code and it provides more progressivity.

My one caveat has to do with the extraordinary level of commitments we now have on the spending side of the budget. My own view, in fact, is that we should not label taxes by the revenues we collect, but that we should label taxes as equal to the spending we actually undertake.

For instance, if we are a household and we spend $20,000 and we only earn $15,000 and we leave a $5,000 debt to our children it does not mean we did not spend $20,000. The amount of collections we have to do to pay off that $20,000 is still $20,000.

And so we have, if you think about it, not a tax rate of 17 or 18 percent of GDP. That represents revenues collected currently. The tax rate we have is equal to the spending rate we have, which is higher and going much, much higher.

So the question on how far you can go in lowering rates is largely going to depend on whether we also get some of this spending under control. You are right, at current levels, given current revenue collections, there is no doubt a broader bass means we can have lower rates. Whether we can lower them relative to what we have currently—given that we are not collecting enough to pay our bills—is a more complex question.

If I could just add one footnote to your question on health care, too, because I have had a number of proposals exactly along the lines that both you and Mr. Greenstein talked about: to try to cap or somehow or another limit the current exclusion and convert it toward a credit or a voucher. This is the direction that most of us think that we should go.

It is not just an issue of being more progressive. The current subsidy, because of the way it is designed, at the margin increases the demand for health insurance—expensive health insurance—which increases the demand for health care, which makes health care more expensive, which increases the number of uninsured.

So we have the extremely perverse situation right now where the current subsidy is not only not buying more people into the insurance market. We are spending more every year to pay for more people to be uninsured. It is that perverse.

The issue of what we actually enact down the road is one over which there will be controversy. That should not, I think, deter us from saying we have to cap, at least cap, these subsidies—cap some of these very perverse programs. This is on the tax subsidy side. We could look on the spending side, too, and not let programs there automatically grow when they are operating so perversely.

If we only get to capping them when we finally are in agreement was to what the ultimate health reform is going to be, or the ultimate tax reform, then I think we are in trouble.

Senator WYDEN. Mr. Chairman, I could not improve on the last comment. And I thank you for the questions.

Chairman CONRAD. Thank you.

Senator SANDERS.

Senator SANDERS. Thank you very much, Mr. Chairman, for holding this important hearing.

Let me start off with Mr. Greenstein and others, Dr. Reischauer and others, can pick up on it.

What impact on the deficit situation would occur if tomorrow the Congress rescinded all of President Bush's tax breaks that went to the wealthiest 1 percent?

Mr. GREENSTEIN. I would have to get back to you with the specific figures. In my testimony I note that if all of the 2001 and 2003 tax cuts, not just those for the top 1 percent, either expired or to the degree they were extended were paid for, that three-fifths, 60 percent, of the fiscal gap through 2050 would be eliminated.

Now I am trying to recall, the tax cuts for the top 1 percent or what about a third of the total? About a third of the total. So it would close about one-fifth of the fiscal gap through 2050. That is assuming one did it now.

The reason the effects would be this large would be that—in anything in the tax and expenditure area, the sooner you do it, the more years over which the interest payment savings compound. And therefore over a period going out to 2050, you get a big effect.

So on these long-term projections to 2050, the top 1 percent would close about a fifth of long-term fiscal gap and the tax cuts as a whole about three-fifths.

Mr. STEUERLE. Can I put it in some other numbers? The tax cuts of President Bush are on the order of 1 to 1.5 percent of GDP, depending on how we measure it. So if you take about a third of that, you are talking about one-third to one half of 1 percentage point of GDP.

And just by way of comparison, the scheduled growth in Social Security and Medicare and Medicaid is on the order of about 6 to 8 percentage points of GDP over 50 years.

So these tax cuts may solve some of the fiscal gap in the short run, if you assume a lot of things inherent in Bob's projections, which includes a constantly declining share of the national income that goes for discretionary programs and a lot of other things.

The comparison I usually make is what is the size of the tax cuts relative to how Social Security and Medicare and Medicaid are continually dominating the budget and usurping other spending? I think it has to be put in that context.

Mr. GREENSTEIN. I think both ways of looking at it are important. Again, as I said in the testimony, if one dealt with all of the Bush tax cuts tomorrow, we would still have an unsustainable long-term fiscal path for the reasons Gene mentions. If we were to look at a period longer than 2050, which I do not recommend given the uncertainty of numbers, dealing with the tax cuts would close a smaller percentage of the hole.

One last small point. Our estimate of the impact of the tax cuts is a little closer to 2 percent of GDP. The difference between Gene's figure and the one I am citing is simply the following: when we talk about the cost of the tax cuts, we are including within them the increase in the cost of Alternative Minimum Tax relief that was created by the tax cuts. The 2001 and 2003 tax cuts doubled the number of people subject to the AMT and more than doubled the cost of AMT relief.

So I am including that cost in my figure. And when you do, it is closer to 2 percent of GDP.

Senator SANDERS. Next week the President is going to provide us with his budget. He has, as I understand it, already indicated that he wants his tax breaks to be made permanent and he wants to move this country to a balanced budget, I believe, in 5 years.

We will find out soon enough, but it sounds to me that if you are not going to rescind any of the tax breaks, and if you can move the country to a balanced budget in 5 years, there are going to be some pretty savage cuts on programs that lower income people and working people are now dependent upon. Am I missing something in that guess? We will find out soon enough but is that a fair assumption?

Mr. GREENSTEIN. I think that is probably right. I do not think that is the only factor. I think the President will present a 5-year budget and that if you extended it beyond 5 years, you would find the deficits would come back up as time go by.

I think the President will help himself get to the goal by leaving some costs out. For example, I think he will assume in 2012 that there is no AMT relief, that 40 million Americans are subject to the AMT. That will lower the cost of his own tax cuts on paper in 2012, there is a $95 billion—

Senator SANDERS. You are not suggesting he is going to raise taxes on tens of millions of people, are you?

Mr. GREENSTEIN. I am just saying I think that is the way the budget numbers will be arrayed. And because he is doing that, the size of the domestic cuts he needs to show balance on paper in 2012 will be smaller than if he assumes that AMT relief continued.

Even with that though, I do think the budget will have significant cuts. I think a lot of them will be unspecified. I think he will show a big reduction in 2012 in overall domestic discretionary programs, but that there will be no specifics after 2008 for what the cuts in the domestic discretionary programs are.

Mr. REISCHAUER. It is also conceivable that the budget might contain some significant Medicare savings. As you know, next year the Congress and the President will be faced with a 45 percent of general revenue limitation on Medicare expenditures, which will cause the President to submit and you to consider a package of policy changes that bring Medicare spending in compliance with that restriction. And the budget could contain possibly unspecified Medicare cuts in 2012.

Mr. STEUERLE. Can I just add one tiny footnote here? We are doing some projections at the Urban Institute on the children's budget, seeing how much children are getting out of the budget. They are already scheduled right now to get a decline, even before you have any additional savings, because their share of domestic spending is being squeezed between what is happening with the tax cuts and what is happening with the continuing orientation of the budget toward us baby boomers. They are starting to get the short shrift already.

Senator SANDERS. This, by the way, at a time when we have the highest rate of childhood poverty in the industrialized world.

The only point that I would make, Mr. Chair, to conclude my remarks, is when we talk about health care let us never forget as part of that discussion that the United States spends almost twice as much per person on health care as any other industrialized nation while at the same time we have some 47 million Americans who have no health insurance at all.

I think it is widely understood that our system, our non-system—it is not a system—is the most inefficient wasteful and bureaucratic of any in the industrialized world.

Mr. Chair, thank you very much.

Chairman CONRAD. Thank you, Senator.

Senator CARDIN.

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

Let me thank all of our witnesses for their testimony.

I must admit, this has been a frustrating exercise for many, many years here in the Congress. I listened to similar testimony as a member of the Budget Committee in the House. And I just want to thank the Chairman for having this hearing on long-term fiscal challenges, because I see us act over and over again, session after session, on short-term objectives, and we have not addressed long-term needs.

Dr. Reischauer, you point out, and I think rightly so and you are not the first witness before this committee to point this out, that unless American households and businesses increase their savings very dramatically, the continued viability of our Nation's economy will depend increasingly on the willingness of foreigners to accumulate ever larger holdings of dollar dominated assets. We have heard over again about the vulnerability of our economy. And our economy's growth, in large measure, will not generate the revenues we need to balance the budget long-term.

I would be interested as to whether you have certain suggestions as to how we can make a dramatic increase in our savings as a Nation through proposals that have some degree of political viability.

Mr. REISCHAUER. I think, as my colleague at the Urban Institute, Ned Gramlich, and others have pointed out to this committee, we seem to be incapable of devising policies or encouragements that cause the American public to increase its savings. And the most efficacious way to raise national savings seems to be to reduce Federal deficits.

And that, of course, throws the ball back into your court. And as you said, it is very difficult to get Congress to address that issue.

Senator CARDIN. I agree with you. I think that we could really increase national savings if Government took less money out for refinancing its own operations.

I want to talk, though, about Medicare issues because, as you point out, the President is likely to come forward with some Medicare cuts in his budget. In the 1997 Balanced Budget Act, we made a very difficult decisions in cutting Medicare costs, thinking that we were lowering health care costs in this country.

Mr. Greenstein, I agree completely with your statement that increases in health care costs per beneficiary in Medicare and Medicaid essentially mirror increases in costs per beneficiary in the overall U.S. health care system. So unless we deal fundamentally change the health care in this country, and change the way that we deliver care in a fundamental way, instead of picking on Medicare will do little to bring down health care expenditures. We might shift costs around. We might limit access to care. But it will have limited effectiveness in lowering overall costs of the Medicare system.

Senator CARDIN. I saw in 1997, when we changed the physician reimbursement system and thought we were doing something that would reduce costs. The resulting system has not done that. And the use of SGR has created a great deal of inequities within the system itself.

I am worried, as we look at Medicare to solve the health care cost issues at the national level, we are liable to cause real access problems for our seniors and shift additional costs on to them rather than fundamentally addressing the health care crisis.

I welcome your thoughts on that.

Mr. GREENSTEIN. I agree, and that was the theme of my testimony and a lot of the discussion today, that we are not going to get big dramatic long-term savings, big dramatic long-term reductions in the rate of growth and Medicare costs without larger health care system reform.

I would note, however, that—I do not know whether the President will include these in his budget or not—but there are proposals that the Medicare Payment Advisory Commission, that Bob Reischauer is Vice Chair of, has proposed that would get some savings in Medicare without harming beneficiaries. They have identified areas where Medicare is actually overpaying, such as in areas where private plans are getting paid more by Medicare than it costs Medicare to serve the same people in fee-for-service. So there are some adjustment that Congress can, and I think should, make it short order.

Senator CARDIN. Let me disagree with you on that. There are areas obviously we need to reform.

Let's take the Medicare physician reimbursement system. We all know we are going to make modifications to it because it is not sustainable in its current form. Those modifications are not built into the future projections of Medicare spending. They should be.

The therapy caps are not sustainable for outpatient physical, occupational, and speech-language therapies. We know that. We keep on modifying it every year. Those caps were imposed arbitrarily in 1997 purely to get cost savings. They were added without hearings and without consideration of the impact on patient care. Eliminating the caps and ensuring access will cost Medicare more money in the future.

Congress enacts these cuts because it makes short-term budgets appear more manageable; but in doing so, it has built additional accrued liabilities into the Medicare system. This is because Congress knows it is not going to allow those policies to persist because they are not sustainable from a medical policy perspective.

Mr. GREENSTEIN. Agreed. And let me defer to Bob here, but I would hope that you will make some of those adjustments for sure, as you have been doing each year.

One could finance them and maybe get some net savings with some of the MedPAC recommendations. I think those are sounder than simply continuing on, I forget what it is, 4.5 percent, whatever the reduction in Medicare physician payments are.

But I think the MedPAC recommendations, I would put them in a different category and I think they deserve careful scrutiny.

Senator CARDIN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

I would like to just say to the three of you, we have had three hearings before this one. We have had the head of the General Accounting Office, David Walker. He said to us our long-term situation is completely unsustainable.

We had the Chairman of the Federal Reserve, Ben Bernanke. He said to us we should have been working on this 10 years ago, that the budget, the fiscal outlook for the country, is completely unsustainable.

Then we had the head of CBO, and he delivered some good short-term news, that is deficits somewhat reduced this year from what was previously thought. But he warned very clearly that our long-term situation is unsustainable.

The three of you have come. The three of you are three of the most respected people in the country on these issues. The three of you each have a long track record and very substantial credibility on both sides of the aisle. That is why you are asked to repeatedly come before this committee, because you have credibility. You are warning us of the long-term circumstance.

I would just like, before we conclude, to ask each of you to give us your best idea to deal with the short-term and long-term. So what is your best idea to deal with these things short-term and your best idea to deal with the challenges we confront long-term?

Mr. GREENSTEIN. I do not think any of us have a silver bullet. I would distinguish between areas, like Social Security and various things in the revenue area where we know what the options are but the political will has not been there, and the health care area we have been talking so much about where we do not know exactly what the things are that will yield savings of X amount and deal with the big drivers of systemwide health care cost growth that, in turn, are driving Medicare and Medicaid costs upward.

Given how heavy these lifts are, I do not see how you get there from here without a bipartisan agreement that includes both ends of Pennsylvania Avenue. And if it takes several years to get there and to build the basis for that, then it does. But the sooner we start, the better.

I think we need to get the public—members of Congress on both side of the aisle, but the public, they are all related, you represent the public—beyond thinking that various things just have to be off the table. We cannot touch a dime in anybody's future benefits in Social Security. We cannot change anything in the 2001 and 2003 tax cuts. As long as there are those barriers, you will not make progress because until you can deal with all of those things, I do not think you will be able to make many of the really big decisions.

As I urged earlier, I do think—this is a sort of a suggestion, to use a cliche, to walk and chew gum at the same time. That as you, you and Senator Gregg, Secretary Paulson, whoever, are trying to get things started on what is probably going to take awhile on the long-term, at the same time to identify what things can we do immediately first to stop the practice of recent years of digging the hole deeper with every session of Congress.

And second, to look for those things that can start to make some progress right away, even though they are going to be modest compared to the bigger things you ultimately have to do.

Chairman CONRAD. Mr. Reischauer, what would you recommend?

Mr. REISCHAUER. The problem here, of course, is that there is no mechanism to force action and there is no ability to provide protection, political protection, for those who might make the difficult decisions. In a democracy, it is terribly hard when the sun is shining to convince people to buy a raincoat and an umbrella for inclement weather that may happen 3 weeks from now, may happen 2 months from now, may happen next year.

And so what we need is to make the discussion, that you have heard three times now from your various witnesses, more real. The tendency over the last decade or so has been for individuals like us and the leaders that have testified before you in the earlier sessions to paint the picture in ever more dramatic terms. Billions turn into trillions, the crisis is looming in the future. But this has no reality for people.

And I think the first and only thing I would have to offer is that we really need Presidential leadership. I do not think this is an issue that Congress can lead on. Congress can follow, Congress can join hands with—must join hands with the executive in this. But there is an important educational role that only the president can play. And this should be cast not in terms of shared sacrifice or pain or avoidance of disaster, but rather as an investment, an investment for our children and our grandchildren.

Because as several of us have pointed out, we are really going to hand off to our children and grandchildren an economic and budget situation that will bedevil their lives.

And this, like investments in physical capital, infrastructure, technology, is very much a very real way of improving their living standards in the future.

Chairman CONRAD. Dr. Steuerle?

Mr. STEUERLE. Senator, again thank you for this opportunity to be here, and thank you for the compliments you made to all of us.

In my view there are some things that the committee can do. In part, they have to do with presentation.

I gave one example in my testimony. I think we need to have ways of showing what is happening both automatically and on a discretionary basis in the budget as a whole, so that you can see how much of the revenues you are going to have in the future whether three-quarters or 120 percent, depending on what period you are looking at—are already committed. I think that is an important part of the process.

It is also important to change the language so that when we talk about increasing education spending by 1 percent in nominal terms, and cutting it 2 percent in real terms, that is not called an increase. When we cut Medicare spending from an 8 percent to 7 percent, we should not call that a cut. That is because we are measuring it not relative to current levels, but we are measuring it relative to something we call "current law" a concept that nobody in the public understands, and, I would guess, most members of the Congress do not understand, and, quite honestly, I do not even fully understand if you really ask me for every detail. I think that presentation is enormously important.

One reason is to make our language more accurate to garner the cooperation of the baby boomers who are about to retire. Because if we are really talking about where the money is, it is in Medicare and Social Security. That is, it is largely the baby boomers who are scheduled to garner almost all of the expenditures of Government. We have to convince ourselves, in some sense, that we are part of the solution.

I will say—and I did not get into this issue because I did not have time in my oral testimony—I think there is enormous opportunity in this approach. As I mentioned before, I think the budget is upside down. We are spending more in areas where we are actually improving as an economy.

Older people 55 to 75 represent for the first half of the 21st century what essentially women did for the last half of the 20th century. They have enormous human capital that has been underutilized in the labor force. In every reform you look at, I would really encourage you to look at how we can encourage more work out of this more mature, yet not old, population. Because more work means we do not have to increase tax rates or cut benefits rates because there is more income in the economy and more revenues.

As a practical matter, and several of us mentioned this earlier I think you could also work on triggers. I do not think triggers are perfect, but they least force some action. When Social Security is projected to be out of balance, there could be a trigger that says we cut back on the automatic growth.

The same thing in Medicare. There is a trigger now, which does not have a lot of mileage to it, but it requires the president to give you a proposal when Medicare spending exceeds a certain portion of general revenues. I think it needs a few more teeth. I think we could work on some triggers that at least force action. That is not a long-term solution to these programs but I think it is a important partial step.

Chairman CONRAD. Thank you. Thank you for that.

Senator ALLARD.

Senator ALLARD. The next two questions I have, I am just going to try to push the limits a little bit and just see what you think about some things that we are looking at.

We have had suggestions from the Federal Reserve as well as the Board of Trustees of Social Security, that to get us out of the unsustainable mode on Social Security and Medicare and Medicaid that what we need to do is we need to apply—particularly in Medicare and Medicaid—we need to apply kind of a gross domestic product plus one formula.

In other words, you take gross domestic product, you limit spending increase to Medicare and Medicaid to 1 percent over that over the next 10 years. What that spells out in percentage of reducing Medicare spending would be by 2 percent and it would reduce Medicaid spending by 3 percent over this period of time.

Do you think that is reasonable?

Mr. REISCHAUER. The question is not the reasonableness of the objective, but how one would implement it, what one would do to bring compliance. Would we cut payments? Would we reduce the number of people eligible for the program? Would we increase premiums paid and cost-sharing by the beneficiaries?

That is where the rubber hits the road.

Mr. GREENSTEIN. I would add, I think there are problems in trying to enforce such a target in the absence of reform in the overall health care system. Take Medicaid as an example. Studies at the Urban Institute, that Bob is the President of, find that Medicaid costs per beneficiary are lower on average than costs per beneficiary of people in comparable health in the private sector system. The principal reason is Medicaid pays providers less. Some providers will not participate in Medicaid as a result. If one cuts those payments a lot more without changing the fees charged in the private sector, one can destabilize the program.

Or another issue. Working poor parents. In the typical State, the income limit for Medicaid for working poor parents is two-thirds of the poverty line. You make 70 percent of the poverty line, you are uninsured unless your employer covers you in the typical state. You are too rich to get insurance.

So we do not want to start making blunt instrument cuts in areas like that. That is why it comes back to this larger issue that we have to grapple with the overall health care system. We cannot just single out Medicare, and in particular Medicaid and put artificial caps on the growth if the health care growth systemwide continues at a significant higher rate.

Mr. STEUERLE. I mentioned earlier that the Government, through its expenditures and its tax subsidies, is now spending $11,000 per household, rising to $13,000 within 4 years. The rate of increase could go up even faster after that.

I think a systematic look at how this money is being spent could lead to some proposals that would allow you to be pretty tough in terms of capping Medicare expenditures, even having for instance, by enacting rules that would be somewhat arbitrary in the limited price increases or the price decreases you might force on various medical services.

But I think I would take some of that money and direct it toward other problems that my colleagues have mentioned. I would also move a bit in the direction the President has suggested (but not adequately), and perhaps start building up a credit or a voucher for the non-elderly.

I think that combination would accomplish several things. One, I think it would allocate the health budget better. Two, if you applied some of the savings as a deficit reduction, I think it would represent good budget policy. But three, as a political matter—and I do not usually try to jump in political matters—I think it would convince the public that you are trying to come out with a better health care budget overall.

It would force, of course, attention to the huge disparities in the way spending is done on both the tax and the direct spending side of the budget.

So I think one can go in the direction or suggest. I think it would be hard. You probably would have to empower much more strongly your MedPAC-type commissions. Bob might not like that (he's on the commission) or he might tell me there are limits on how far you can go in the direction or suggest. For instance, a commission might). That if they make suggestions, you would take them or you would give them some fast track or something and only—there are all sorts of details here.

But I think the objective is a good one and I think there are ways to try to move toward it.

Senator ALLARD. Mr. Chairman, I just have one more question.

Now we have talked about a solution on the spending side and now I am going to push you a little bit on the revenue side. Because my view is that we are not going to get any kind of political resolution to this until we deal with both sides, the spending and revenue side. Probably, from a practical standpoint, we are going to have to do that anyhow.

So let us look at marginal tax rates. In the 1940's, marginal tax rates were as high as 94 percent. They are now 35 percent. How high do we raise marginal tax rates? Or do we leave them where they are because they are—apparently, they are an economy driver. If you look at adjusted inflation revenues, it has increased from $75 billion to $1.9 trillion in revenue to the Federal Government.

So do we look at bringing our marginal rates close to 94, to 90 percent or something like that? What is appropriate, 70 percent, 50 percent, or something less? Or do we even mess with marginal rates?

Mr. REISCHAUER. I think there is probably a consensus at this table that keeping marginal rates low is good and broadening the base is a preferable way to raise revenues.

That having been said, there are certain preferences that are enjoyed by very high income individuals, some as a result of the tax changes of the last 7 years, which it might be appropriate for Congress to rethink.

Mr. STEUERLE. I would say that if I had to identify one major concern with marginal tax rates—and it does have to do with where we are going with reform—it is that we have built so many explicit tax rates and various phase-outs in the tax system and the direct expenditure system I see low and moderate income people in various income ranges with tax rates that are already 50, 60, 70, or 100 percent. I fear that if we go too much futher toward means testing, as is sometimes suggested on health benefits, we are going to raise those rates even further.

So I have to say, those are the marginal rates I worry about the most.

The economic logic of marginal rates is that the inefficiency of tax system increases with the square of the tax rate. So bumping from 35 to 40 is much less severe than bumping from 40 to 45, if you understand where I am going. As an extreme example jumping from 99 to 100 means basically people would do no work.

So the higher the rate gets, the more I worry about it. Thus, I would especially worry, as I say, about the marginal rates we are starting to impose on moderate income people. That requires looking beyond just the statutory rate to all these indirect rates.

And by the way, we are increasing marginal rates right now anyway through policies ranging from things the Alternative Minimum Tax to bracket creep. So we are doing some of it already.

Mr. GREENSTEIN. I think all of us would agree broadening the base and improving compliance is the first step.

Incidentally, when I was noting additional needs in the discretionary area, I forgot to include and should have, IRS enforcement to improve compliance.

Having said that, as Gene just noted, I think none of us would favor going remotely close to the 70 to 90 percent rates you were talking to. I think we may very well need, however, to revisit 35 percent versus 39.6 percent at the top.

Beyond that, over the longer term, I think we will need to look at some other forms of revenue outside the income tax, particularly in the area of environmental related taxes, both to deal with the global warming problems and from a revenue standpoint.

We may ultimately need to look at a small value added tax to help deal with these health care issues that we have talked about at some point down the road. We may need to look at a hybrid of a reformed income tax and some more consumption-based taxes.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. If Senator Allard does not mind, I would like to just followup with something Dr. Steuerle mentioned to you in answer to the question.

I would like you to explain a little more fully if you could, you are talking about very high marginal rates on middle income people. What were you referencing there?

Mr. STEUERLE. What we have done in so many parts of our budget process is to try to save money by playing this game of phasing out programs. I am not saying that in some cases they should not be phased out. But almost all of the phase-outs are based on income.

So, in point of fact, your income goes up by $1 and you lose 10 cents worth of a Pell Grant. Or you lose 33 cents of food stamps. Or you lose 50 cents of some other program.

These programs are each enacted one at a time. I have done a lot of analysis on these marginal rates on low and moderate income people. Many of these people face extremely high marginal tax rates.

Occasionally there is movement to do something about these rates, but then we contradict that effort by adding on another program. And as I say, even some of the proposals in the health care field have implicit in them something like another 33 percent phase-out rate. So you earn another $1 and you lose 33 cents of your health voucher or your health credit or whatever else it is going to be. You add that rate to all the others, and you end up imposing these very, very high tax rates.

In the tax system we do it a bit also. We phaseout personal exemptions and other items like this. As far as I am concerned, most of those phaseouts should not be there. If we are going to have rates, let us put them directly in the statutory rate schedule, and let us stop pretending about what is being done. We play this game of pretending that we lower the statutory rates, and then we come in through the back door and catch people through higher implicit tax rates.

There is very little attention to how this combined tax expenditure system is affecting people.

Chairman CONRAD. I had not thought about that. That is a very interesting point that you are making.

Mr. STEUERLE. They also impose huge marriage penalties, typically, if you look at those also.

Chairman CONRAD. That very significant marriage penalties are imposed by—

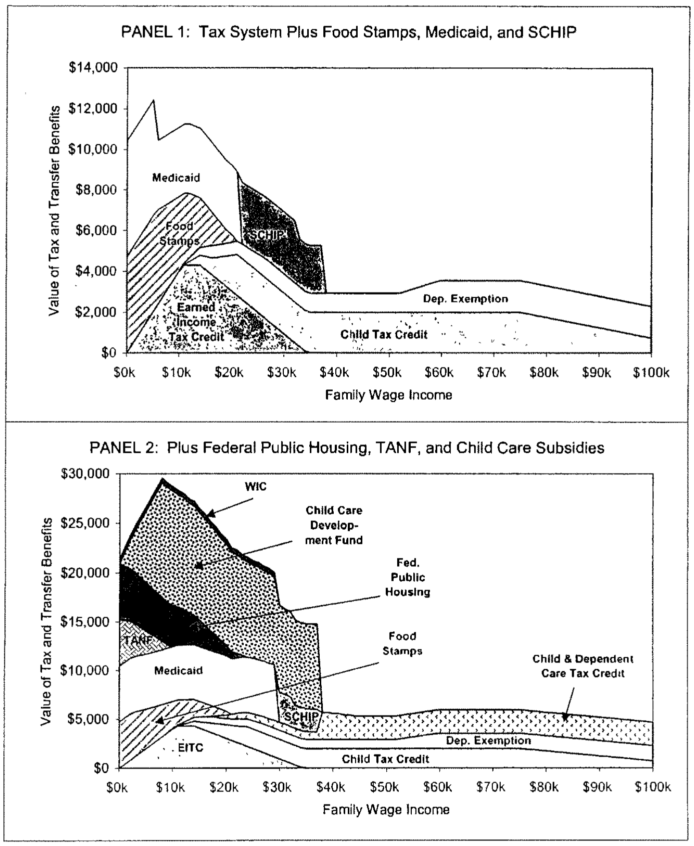
Mr. STEUERLE. Typically by the way these things are phased out. They are often phased out on a household basis. As long as you stay single, you can avoid some of the phase-outs, is what often happens...

Mr. GREENSTEIN. You could have a household of $20,000 year. As it earns more money, its EITC goes down. If it has a housing voucher, that goes down. If it has food stamps, that goes down.

These are the points Gene is making, I think. If you look at both the tax and the transfer, the means tested program side of the ledger, and you add them up, for each additional $1 you earn, you can lose more than 50 cents. You can have a higher marginal tax rate than people at the top of the income scale effectively.

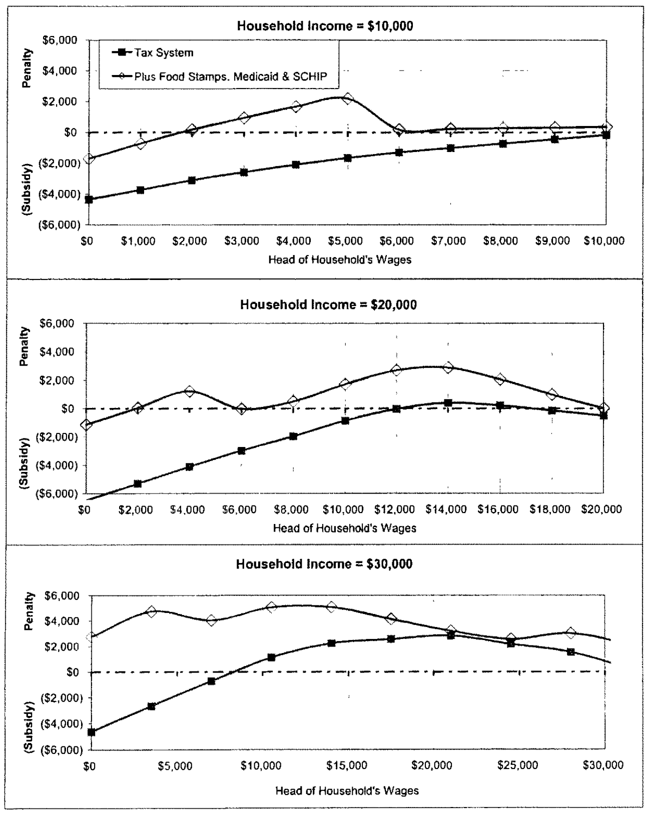
Chairman CONRAD. I would be very interested in anything you have in writing on this, I would be very interested in reading.

FIGURE 1: Select Tax and Transfer Benefits for a Head of Household with Two Children in Tax Year 2004



Source: Calculations by Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2005. Notes: Child ages are assumed to be 2 and 5. Tax calculations include the alternative minimum tax and assumptions on itemized deductions. Transfer programs apply rules for Pennsylvania, which is the median TANF benefit state. We assume $5,000 maximum annual child care costs. Note that in the second chart, the adults in a family previously on TANF remain eligible for Medicaid up to 185% of poverty (for up to 12 months after leaving TANF).

FIGURE 3: Dollar Amount Of Marriage Penalties And Subsidies In Select Federal Tax And Transfer Programs For A Married Couple With Two Children In Tax Year 2004
(Assumes a single earner marries a head of household with two children who earns 0% to 100% of couple's income)



Note: The "Secondary Earner" was a head of household with two children, prior to marriage. Her earnings range from 0% to 100% of household income in each example. The Primary Earner earns the balance, and was a single filer without children, prior to marriage Marriage penalties and subsidies include the effects of Social Security taxes (both the employer and employee portion) and state income taxes
Source: Calculations by Adam Carasso and C Eugene Steuerle, The Urban Institute, 2005

Let us bring the hearing to an end. We have reached the appointed hour.

I just want to stay personally and on behalf of the committee a special thank you to this panel. I think this has been extremely constructive. It has certainly helped my thinking.

Mr. Greenstein, thank you once again for appearing before the panel.

Dr. Reischauer, thank you. We have missed your steady hand at CBO. We have been very gifted, in this committee and the Congress, in who we haveten to replace you and we are delighted there.

Dr. Steuerle, thank you for your very thoughtful presentation here today. We appreciate it.

[Whereupon, at 12:13 p.m., the committee was adjourned.]

EXPLORING SOLUTIONS TO OUR LONG-TERM FISCAL CHALLENGES

WEDNESDAY, JANUARY 31, 2007

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, Whitehouse, and Gregg.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. I would ask the witnesses to take their seats. Senator Gregg has just informed me that he is running a little bit late, but he has asked me to go ahead and begin the hearing, and we will do that.

I especially want to welcome the really outstanding witnesses we have here today. Robert Bixby, the Executive Director of the Concord Coalition, that does such good work on trying to alert the Nation as to the risks of our fiscal imbalances; Dr. Joe Minarik, the Senior Vice President of the Committee for Economic Development with a distinguished background in dealing with these issues; Dr. Jason Furman, who is the Director of the Hamilton Project at the Brookings Institution, who has just taken over for Peter Orszag, who has now become the head of the Congressional Budget Office; and Dr. Stuart Butler, the Vice President of the Heritage Foundation. We look forward to the testimony of all of you.

Let me just say that we have had a series of hearings now in which we have tried to lay the groundwork about the seriousness of our long-term fiscal imbalances. We started with the head of the General Accounting Office, and maybe we could put up one of his statements from that hearing. He said we are on an imprudent and unsustainable long-term fiscal path, and while the short-term deficits have improved in recent years, the long-term is getting worse every second of every minute of every day, and the time for action is now.

GAO Comptroller General Walker on Solving Nation's Fiscal Problems

"We are on an imprudent and unsustainable long-term fiscal path, and while the short-term deficits have improved in recent years, the long term is getting worse every second of every minute of every day and the time for action is now."

– Government Accountability Office
Comptroller General David Walker
Testimony before Senate Budget Committee
January 11, 2007

Next, we had the Chairman of the Federal Reserve come and testify before the Senate Budget Committee, and this is what he had to say: one might look at these projections and say, well, they are about 2030 or 2040, and so we really do not have to start worrying about it yet. But in fact, the longer we wait, the more severe, the more draconian, the more difficult the adjustments are going to be. I think the right time to start is about 10 years ago.

Federal Reserve Chairman Bernanke on Budget Outlook

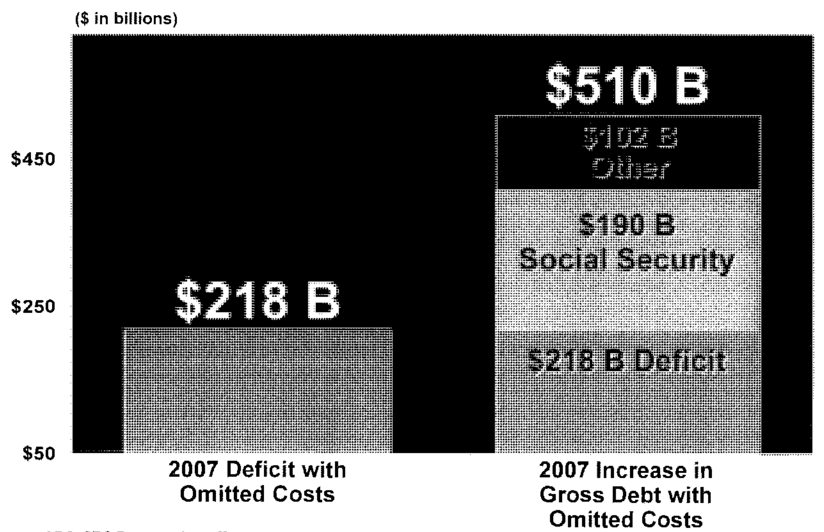
"... [O]ne might look at these projections and say, 'Well, these are about 2030 and 2040 and ... so we don't really have to start worrying about it yet.' But, in fact, the longer we wait, the more severe, the more draconian, the more difficult ... the adjustments are going to be. I think the right time to start is about 10 years ago."

–Federal Reserve Chairman Ben Bernanke
Testimony before Senate Budget Committee
January 18, 2007

I think the Chairman of the Federal Reserve had that exactly right.

Even in the short term, our fiscal outlook is worse than some have claimed. It is important to remember that the debt is growing far faster than the size of the deficit. While CBO estimates with omitted costs that the deficit will fall to $218 billion in 2007, that number only tells part of the story. The increase in the debt will actually be over $500 billion for this year. As I have said to my colleagues over and over, the debt is the threat.

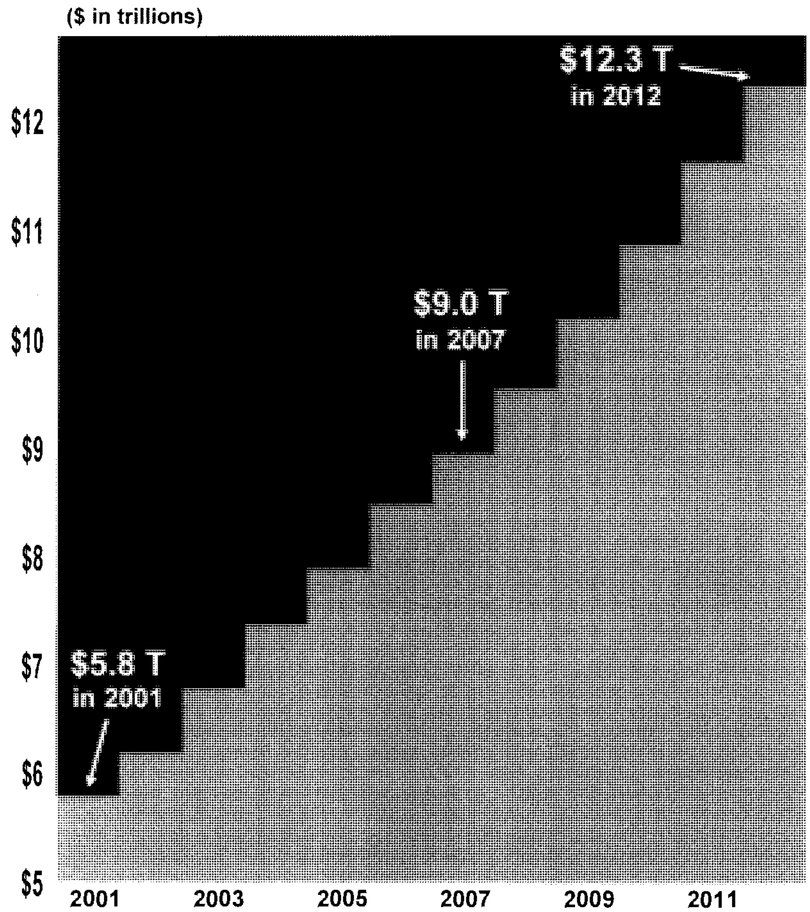
Increase in Debt in 2007 is Far Greater Than the Estimated $218 Billion Deficit



Source: CBO, SBC Democratic staff
Note: Omitted costs include supplemental funding for the wars in Iraq and Afghanistan, AMT relief, and expiring tax provisions.

We are now facing a wall of debt. At the end of 2001, the first year of this Administration, the gross debt was $5.8 trillion at the end of that year. Under CBO's most recent estimates, the gross debt of the United States will reach $9 trillion this year. And we are headed, by the year 2012, for a gross debt of the United States of over $12 trillion.

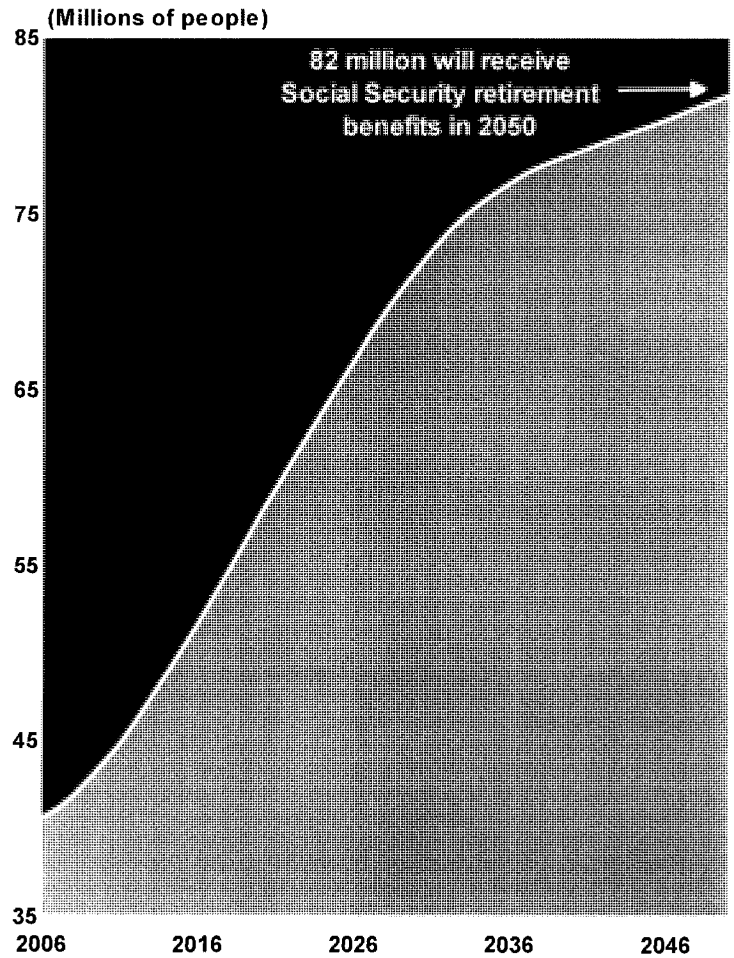
Building a Wall of Debt
Gross Federal Debt Soars



Source: OMB, CBO and SBC Democratic staff
Note: CBO January 2007 estimate with tax cuts made permanent, AMT reform, ongoing war costs, Bush defense buildup, and without extension of 2007 emergency funding.

This increase in debt is happening at the worst possible time, just before the retirement of the baby boom generation. As this slide shows, the number of Social Security beneficiaries is projected to climb to 82 million by 2050.

Number of Social Security Beneficiaries Explodes with Retirement of Baby Boom Generation



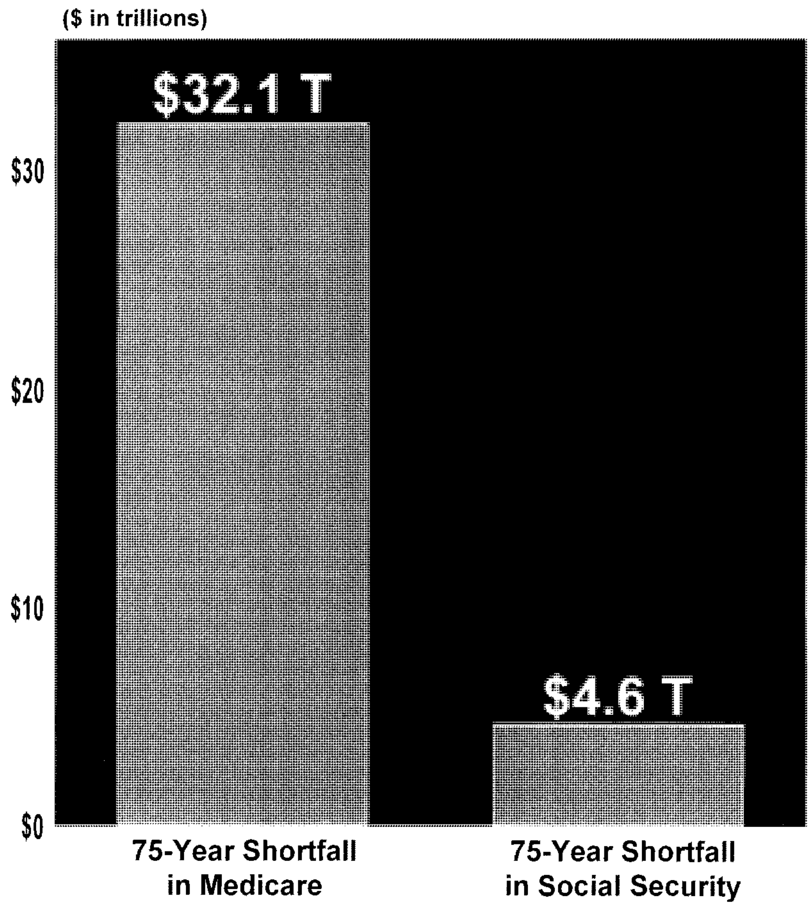
Source: 2006 Social Security Trustees Report
Note: OASI beneficiaries

May 9

And we need to remember that Social Security is not the biggest budget challenge that we face. Because of rising health care costs, the shortfall in Medicare is seven times the shortfall in Social Security.

Comparing Long-Term Costs of Medicare and Social Security

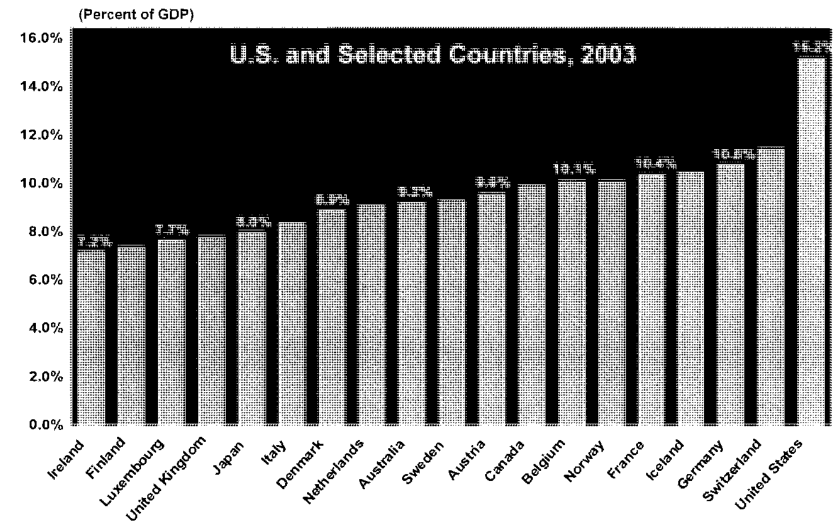
Present Value of Costs Over Next 75 Years



Source: Social Security Trustees 2006 Annual Report

Since so much of our long-term budget shortfall can be attributed to rising health care costs, health care reform must be at the heart of any solution. Our health care system is not as efficient as it should be. The U.S. is spending far more on health expenditures per capita than any other country in the developed world.

Total Health Expenditures as a Share of GDP



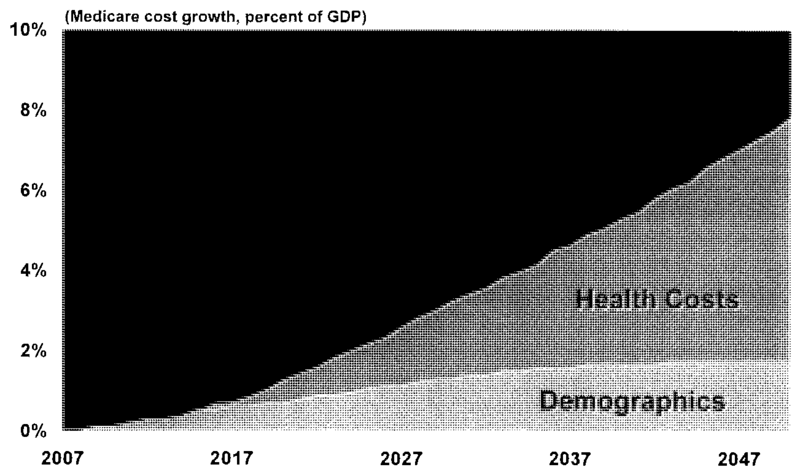
Source: Organization for Economic Co-operation and Development, October 2006

For example, the U.S. spent over 15 percent of GDP on health expenditures in 2003. This year we are expecting we will be at 16 percent of gross domestic product. That means about one in every six dollars in this economy is going for health care.

And if we compare that to the rest of the world, we see that we are spending about twice as much as other industrialized countries. In fact, the next highest country is at 11 percent of GDP. That difference, the difference between the 16 percent of GDP we are spending and the 11 percent of the next highest country, that difference represents $800 billion of expenditure per year in our country.

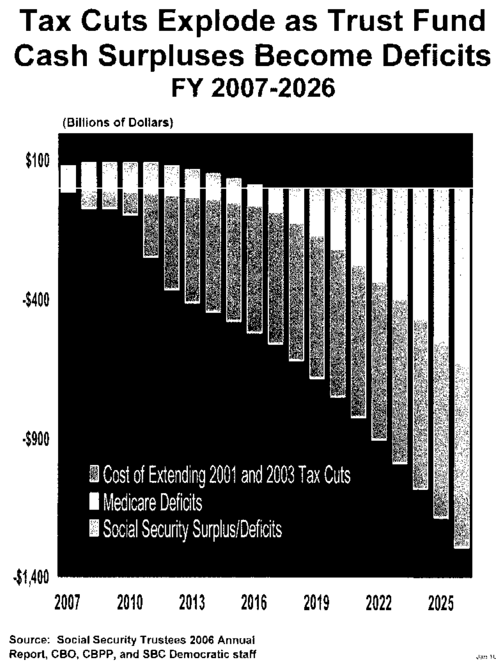
This chart from the Center on Budget and Policy Priorities shows that rising health costs are by far the biggest factor driving Medicare cost growth. Demographic changes from the retiring baby boom generation are a secondary factor, nonetheless a powerful driver as well.

Rising Health Care Costs Driving Medicare Cost Growth

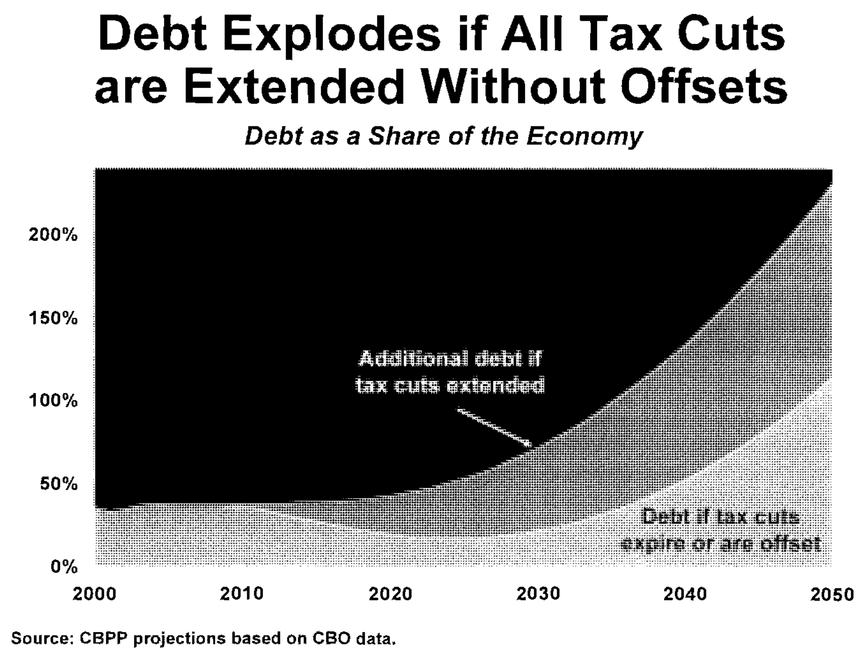


Source: CBPP projections based on CBO data.

But we do not have just an entitlement spending problem, we also have a revenue challenge. If all of the President's tax cuts are made permanent, the cost will explode at the same time that the cash surpluses in Social Security and Medicare become deficits. In other words, the President's tax cuts will dramatically worsen an already deteriorating fiscal picture.



We can see that the Nation's gross debt explodes if all the tax cuts are extended without offsets. In fact, according to the Center on Budget and Policy Priorities, we will more than double our debt level as a share of GDP by 2050 if all of the tax cuts are extended without paying for them.



Our fiscal problems are not insurmountable. We can put our fiscal house back in order, but only if we have the will to do so. Make no mistake, it is not going to be some automatic mechanism that is going to save us. It is going to require us to act. The sooner we act, the better.

We have asked all of you to be here today to give us your ideas on what we might do to address these challenges. I especially appreciate your taking your time to prepare testimony and to be here to give it. I believe these are incredibly difficult challenges. If these were easy things to address, we would have done it. My own conviction is it is going to take both parties giving up on some of their fixed positions in order to resolve this. I do not believe either party can do this on its own. I think it is going to take working together to arrive at solutions. And I do believe it is going to require compromise.

Compromise means both sides have to give in, both sides. Anybody that thinks it is just going to be one side, I think, is not living in the real world.

And so I want to again welcome this panel of witnesses and ask you, Mr. Bixby, to begin your presentation to the committee.

STATEMENT OF ROBERT L. BIXBY, EXECUTIVE DIRECTOR, THE CONCORD COALITION

Mr. Bixby. Thank you, Chairman Conrad and Senator Gregg and other members of the committee. I am very pleased to be here to discuss solutions for the long-term fiscal challenges that you have laid out.

As you mentioned, I represent the Concord Coalition, which is co-chaired by two of your former colleagues: Warren Rudman of New Hampshire, a Republican, and Bob Kerrey of Nebraska, a Democrat.

The problems that we face are well defined. You and your prior witnesses, have laid them out. Basically an aging population and rising health care costs lead to unsustainable deficits and debt over the future.

We can debate, I think, whether the Government should tax and spend at 18 or 19 percent of GDP or tax and spend at a higher level, 25 or higher. But no one would advocate that we tax at 18 or 19 percent of GDP and spend at 25 to 30 percent of GDP. That would certainly shatter the economy, would be generationally inequitable, and yet that is the path that we are on.

There are no quick fixes to this, but there are certain things that we can begin doing now that would make for a brighter future. The Concord Coalition recently took out a full-page statement in the New York Times and recommended the following four steps: one, balance the budget. Second, began a bipartisn process for addressing, the long-term fiscal challenges, similar to what you and Senator Gregg have proposed doing.

Third, reimpose budget caps and the PAYGO mechanism that applied across the board to both tax and spending policies.

We also recommended that you might begin putting into the annual budget resolution some targets for long-term spending and revenues as a percentage of GDP that would cover several years. And that would help focus more attention because, as you know, we have sort of a myopic budget process and it is sort of hard to focus on the long-term when we are worrying about this year's annual appropriations. Not that those are not important, but it is easy to forget the long term.

So let me just elaborate on some of those points. Balancing the budget, this is not an end in and of itself. It does have long-term benefits. It would increase national savings by ending the drain on national savings caused by deficits. So it would better position us to deal with these long-term fiscal challenges. I think it is also generationally responsible because it would lower interest costs and interest is, of course, a major expense, about 8 percent of the Federal budget. So there are going to economic and generationally responsible outcomes that would come from balancing the budget.

But that is only, of course, a first step. Even if we had a balanced budget by 2012 or sooner, we would still have an unsustainable long-term problem. So getting at that is really the root of this.

The next step is to, as you mentioned, reduce the long-term entitlement costs, really the health care and retirement programs are what is driving this. There are no easy solutions to this, as everybody knows, but the primary source of the long-range fiscal drain is on the spending side. This will require difficult choices.

So the most effective solutions are those, I believe, that would concentrate on ways to rein in the spending. And you cannot get away from the two largest, most popular programs in that regard, which are Social Security and Medicare. I would underscore what you said before, that Medicare is by far the much bigger problem than Social Security.

This is going to require some very hard choices. I would recommend on Social Security, the Concord coalition has always been in favor of steps such as raising the eligibility age. I think the idea of progressive price indexing, which has come up, is one that deserves further consideration. I would avoid payroll tax increases as a first step. If more revenues are needed to come up with a politically and substantively balanced plan, then so be it. I think everything does need to be on the table.

Personal accounts are something that could help increase savings, but the money has to come from somewhere. There is no free lunch. So if we do add personal accounts to the system, I would recommend some sort of dedicated revenue source to pay for them so that they are not just adding to the budget deficit. Because if you have deficit-financed personal accounts, you are not adding to national savings. You are putting it in one pot and then taking it from another.

Medicare is by far the more difficult challenge. My red light is on. Gee, does that mean I do not have to talk about Medicare?

Chairman CONRAD. No. You still get to talk about Medicare.

Mr. BIXBY. I will. I thought I had that timed perfectly.

That really is the toughest thing. There, some of the traditional fixes just do not get you much. Raising the eligibility age does not get you much because most of the costs come from the more elderly people, 85 and older.

So I think there you are ultimately going to have to come up with some mix of limits on benefits, figuring out what the public is willing to afford, what makes sense in terms of a benefit package that we can say that all Americans should be guaranteed, at least in Medicare. It does have to extend to the entire health care system basically. You cannot solve Medicare in a vacuum.

It probably will require more contributions from beneficiaries. I think the idea of adding more income relating to premiums is something that you are going to have to do. And anything we do should try to add incentives for more careful use of resources.

Let me just conclude by saying that we cannot ignore the role of revenues in all of this. As I said before, I do not think raising taxes should be the first option. Low taxes do help economic growth and you do not want to stifle that.

On the other hand, you cannot keep taxes that far below spending for too long without creating economic problems of their own. So that is why everything does, at some point, need to be on the table to come up with a package. And this has to be done, as you said, in a bipartisan way. It also has to be done with the active engagement of the American people.

We are involved, all of us here at this table, in the Fiscal Wake-Up Tour. Dave Walker is involved in that, as well. We have been going around the country holding town hall meetings and talking to the local media. I think any sort of big effort like you are leading here at this committee really needs to bring the public along.

We are finding, one bit of good news if I may, that the public seems to be willing to hear the tough choices. What they want is to make sure that you are serious about them. And if they have to endure benefit cuts, if they have to endure higher taxes, they may not be happy about it. But they are willing to accept it if it will result in a brighter future for their children and grandchildren and not just higher deficits and more of the same.

So I think to end, the good news is that the problem is in our own hands. I think the public is willing to hear the truth. And I congratulate this committee for pursuing this most important issue in a bipartisan way.

Thank you.

[The prepared statement of Mr. Bixby follows:]

THE CONCORD COALITION

Statement of Robert L. Bixby

Executive Director, The Concord Coalition

Exploring Solutions to Our Long-Term Fiscal Challenges

Senate Budget Committee

January 31, 2007

Chairman Conrad, Senator Gregg, and members of the Committee, thank you for inviting me to discuss solutions to the nation's long-term fiscal challenges. It is an important issue for the future health of the economy, generational equity, and the ability of all Americans to enjoy rising standards of living.

I am here representing The Concord Coalition, a nonpartisan organization dedicated to strengthening the nation's long-term economic prospects through sound and sustainable fiscal policy. Concord's co-chairs are former senators, Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). They, along with Concord's President former Commerce Secretary Peter G. Peterson and our nationwide membership, have consistently urged Washington policymakers to produce a credible plan for long-term fiscal sustainability.

In that regard, let me express The Concord Coalition's strong appreciation and support for your recently expressed commitment to work in a bipartisan way to achieve this important goal. We hope it will inspire others.

My testimony today will address key aspects of the long-term challenge and potential strategies for dealing with it. Specifically, I will discuss the importance of:

- Restoring a balanced budget;
- Reforming Social Security and Medicare;
- Ensuring an adequate revenue stream;
- Budget process reform;
- Bipartisan cooperation, and
- Public engagement:

I. Overview

All Americans, regardless of political party or ideological perspective, want to leave a more prosperous, secure and compassionate nation to future generations. Yet, we are putting our nation's future at risk with an unsustainable fiscal policy that promises more debt than prosperity, a level of taxation that we would not tolerate for ourselves and diminished prospects for families to enjoy a higher standard of living.

Beyond fiscal imbalance, today's budget policies threaten to place ever-tighter constraints on the ability of future generations to determine their own priorities or to meet challenges that cannot be foreseen. As the share of federal resources pledged to retirement and health care benefits grows, it will leave shrinking amounts for all other purposes. Generational fairness requires a major course correction.

The real choices require scaling back future health care and retirement promises, raising revenues to pay for them or some combination of both. Americans may have very different views about whether it would be better if the federal government were both taxing and spending at 18 percent of GDP or both taxing and spending at 25 percent of GDP. No one, however, would advocate that the government tax at 18 percent of GDP and spend at 25 percent. This would certainly shatter the economy. Yet, this is the future we are now embarked upon.

While there is no quick fix, there are things we can begin doing now that will result in a much brighter picture for future generations. These do not include "slashing" entitlements or "killing the economy with tax increases." They do require that everything be on the table. The Concord Coalition recently published an open letter to the President and Congress recommending that the following steps be taken immediately:

- Negotiate a bipartisan balanced budget plan
- Begin a bipartisan process to address long-term fiscal challenges
- Restore budget caps and pay-as-you-go rules for new spending and tax cuts, and
- Include long-term projections in the budget resolution

The full text of our letter is attached. Let me elaborate on these points and underscore the importance of public engagement in exploring solutions.

II. Balancing the budget is an important first step

As the budget process gets underway, you will be bombarded with countless proposals for increased spending and demands to preserve and extend many tax cuts. Considered in isolation, many of these proposals will seem worthwhile. Unfortunately we can't have it all. Without the discipline imposed by a balanced budget goal, deficits will be higher and last longer than they would otherwise.

Just as a family anticipating major new expenses, such as a home purchase or college education, must begin to save for these financial obligation, the federal government should be taking steps now to improve its fiscal position in anticipation of the costs associated with the retirement of the baby boom generation.

The most direct action the federal government can take in this regard would be to eliminate the drain on savings caused by the federal budget deficit. Restoring budget balance would lower government borrowing from the financial markets and provide a much needed boost in national savings to help the budget and the economy meet the challenges of an aging population. Working toward the goal of a balanced budget would also provide greater flexibility in the future by reducing interest payments and reducing our reliance on foreign lenders.

Aside from being fiscally responsible, balancing the budget is the goal most likely to be broadly understood, supported and enforced. It is also the most generationally responsible goal. Americans understand that it is wrong to provide ourselves with more government services than we are willing to pay for and then send the bill to our children. The best way to avoid such unjust burden shifting while laying a solid long-term foundation for a strong economy is to adhere as much as possible to the balanced budget goal.

A good first step in improving the budget outlook is to identify savings from eliminating wasteful and unnecessary programs and increasing the efficiency of other government programs as well as eliminating narrowly targeted tax breaks that add to the complexity of the tax code without producing meaningful economic benefit. Such provisions divert resources from more pressing national needs and increase public cynicism about the fairness of the federal budget.

Similarly, as this Committee highlighted in a recent hearing, there is the potential for increased revenues by closing the "tax gap" — the difference between taxes that are owed and the revenues that are actually collected.

While there is the potential for savings in these areas, such relatively painless options will not be enough to get the job done. A serious effort to address the near term deficits will require policymakers to tackle the underlying structural deficit resulting from existing tax and spending policies. Moreover, it will do no good to adopt a balanced budget plan on paper if it is not based on an honest assessment of such items as ongoing military operations, the revenue hole left by reforming the Alternative Minimum Tax (AMT) and all other projections.

There is at least one positive thing to report on the budget front: at $248 billion (1.9 percent of GDP), the deficit in fiscal year 2006 was lower than the $319 billion deficit in 2005 (2.6 percent of GDP). It was the second year in a row that the deficit declined. Another modest decline can be expected in the current year. This does not mean, however, that we are on a smooth and easy road back to balanced budgets.

Budget projections are uncertain, but under plausible assumptions about current trends, deficits would total roughly $5 trillion through 2017. This assumes that funding in Iraq is phased down but not out, that all expiring tax cuts are extended, that regular appropriations grow at the same rate as the economy rather than inflation, and that the Alternative Minimum Tax (AMT) is adjusted for inflation. It also assumes a healthy economy.

Under that scenario, deficits would steadily rise to nearly 4 percent of GDP by 2017. Persistent deficits of that size, while not unprecedented, are nevertheless harmful and would come at a very bad time. They would drain national savings, raise the debt to GDP ratio and increase interest costs at the very time when we should be doing the opposite in preparation for the looming fiscal challenges as the baby boomers retire and entitlement spending balloons.

As government debt increases, interest costs grow as well. These costs add to government spending and are paid for with tax dollars. Interest costs totaled $227 billion in fiscal year 2006. It was the fastest growing major spending category in the federal budget, increasing by 23 percent. We spent more on interest in 2006 than we did on either the federal government's share of Medicaid ($181 billion) or appropriations for military operations in Iraq and Afghanistan ($120 billion). All of this is occurring as we enter our fifth year of economic recovery and with two years of very strong revenue growth.

All of this illustrates the difficulty of achieving your goal, which the President shares, of balancing the budget by 2012 while at the same time using realistic cost estimates for current policies.

A sustainable deficit reduction effort will require all parties to compromise. Starkly partisan budget proposals may appeal to true believers and party loyalists, but a plan to reduce the deficit is unlikely to succeed over the long-term without sufficient political will to enforce it. A successful plan must be capable of resisting pressure to undo the tough choices it contains. The best way to ensure that a plan can stand up over time is to infuse it with broad bipartisan support from the beginning. As the Concord Coalition Board of Directors stated in a December, 2005 statement:

> "If everyone insists on only cutting someone else's priorities, talk about deficit reduction will remain just that. The best way to end this standoff is to agree on the common goal of deficit reduction, put everything on the table—including entitlement cuts and tax increases—and negotiate the necessary trade-offs."

III. Reduce long-term entitlement costs

Getting the short-term deficit under control is only the first step. Even with a near-term balanced budget plan, fiscal policy would remain unsustainable over the long-term. The structural imbalance between future benefit promises for retirement and health care programs and the revenues projected to pay for them must be addressed head-on.

The primary source of the nation's long-range fiscal strains is the rising cost of heath care and retirement programs. Thus, the most effective long-range solutions would be those that constrain the growth of these programs. This will require difficult choices regarding who should receive benefits, what level of benefits can be provided and how those benefits should be delivered.

Any strategy for fiscal sustainability will require reform of our two largest and most popular public programs: Social Security and Medicare. Moreover, the choices that are made in this regard should not be made in a vacuum. Social Security and Medicare tax the same people (mostly workers) to pay benefits to the same people (mostly retirees). What matters fiscally and economically is the combined total cost of these programs. Because controlling health benefit spending will be so difficult, it is all the more urgent to save what we can in Social Security.

A. Social Security reform

There is no good reason why Social Security reform should be kept off the 2007 legislative agenda. The demographic and fiscal challenges facing Social Security in the years ahead are well known. It is understandable that people will disagree on the details of any reform plan. What's needed now, however, is rejection of the "Do Nothing Plan."

It is worth recalling that President Bush is not the first president in recent years to put Social Security on the political agenda. In 1998, President Clinton made Social Security reform one of his top domestic priorities. Here is how President Clinton summarized the problem at a forum hosted by The Concord Coalition and AARP in July 1998:

> We dare not let this disintegrate into a partisan rhetorical battle. Senior citizens are going to be Republicans and Democrats and independents. They're going to come from all walks of life, from all income backgrounds, from every region of this country, and therefore, so will their children and their grandchildren. This is an American challenge and we have to meet it together.

Any Social Security reform plan should be designed to meet three fundamental objectives — ensuring Social Security's long-term fiscal sustainability, raising national savings, and improving the system's generational equity:

- **Reform should ensure Social Security's long-term fiscal sustainability.** The first goal of reform should be to close Social Security's financing gap over the lifetimes of our children and beyond. The only way to do so without burdening tomorrow's workers and taxpayers is to reduce Social Security's long-term cost.

- **Reform should raise national savings.** As America ages, the economy will inevitably have to transfer a rising share of real resources from workers to retirees. This burden can be made more bearable by increasing the size of tomorrow's economy. The surest way to do this is to raise national savings, and hence ultimately productivity growth. Without new savings reform is a zero-sum game.

- **Reform should improve Social Security's generational equity.** As currently structured, Social Security contributions offer each new generation of workers a declining value ("moneysworth"). Reform must not exacerbate--and ideally it should improve--the generational inequity underlying the current system.

Meeting these objectives will require hard choices and trade-offs. There is no free lunch. Policymakers and the public need to ask the following questions to assess whether reforms honestly face up to the Social Security challenge--or merely shift and conceal the cost:

- **Does reform rely on trust-fund accounting?** Trust-fund accounting obscures the magnitude and timing of Social Security's financing gap by assuming that trust-fund surpluses accumulated in prior years can be drawn down to defray deficits incurred in future years. However, the trust funds are bookkeeping devices, not a mechanism for savings. The special issue U.S. Treasury bonds they contain represent a promise from one arm of government (Treasury) to satisfy claims held by another arm of government (Social Security.) They do not indicate how these claims will be satisfied or whether real resources are being set aside to match future obligations. Thus, their existence does not, alone, ease the burden of paying future benefits. The real test of fiscal sustainability is whether reform closes Social Security's long-term annual gap between its outlays and its dedicated tax revenues.

- **Does reform rely on hiking FICA taxes?** Hiking the payroll tax rate to meet benefit obligations is neither an economically sound nor a generationally equitable option. The burden will fall most heavily on lower and middle-income workers and on future generations. A popular alternative to an across-the-board increase is to make more of the earnings of higher income workers taxable by raising the cap on taxable wages. Currently, the Social Security payroll tax (12.4 percent) is capped at $97,500 of wages. This would bring in more money, but as a means of assuring the program's sustainability, raising this cap would be considerably less effective than proponents allege. It would only provide a few more years of positive cash flow to the system and, unless the link between taxable earnings and benefits were to be eliminated, it would add to the system's long-term cost by providing higher benefits to those who need them the least.

- **Does reform rely on new debt?** Paying for promised benefits--or financing the transition to a more funded Social Security system--by issuing new debt defeats a fundamental purpose of reform. To the extent that reform relies on debt financing, it will not boost net savings and may result in a decline. Without new savings, any gain for the Social Security system must come at the expense of the rest of the budget, the economy, and future generations. Resort to borrowing is ultimately a tax increase for our kids.

- **Does reform rely on outside financing?** Ideally, reform should achieve all necessary fiscal savings within the Social Security system itself. Unrelated tax hikes and spending cuts may never be enacted, or if enacted, may easily be neutralized by other measures, now or in the future. Unless the American public sees a direct link between sacrifice and reward, the sacrifice is unlikely to happen.

- **Does reform use prudent assumptions?** There must be no fiscal alchemy. The success of reform should not depend upon rosy projections of future economic growth, presumed budget surpluses or lofty rates of return on privately owned accounts. All projections regarding private accounts should be based on realistic assumptions, a prudent mix of equity and debt, and realistic estimates of new administrative costs.

While fixing Social Security's problems, reform must be careful to preserve what works. Social Security now fulfills a number of vital social objectives. Policymakers and the public need to ask the following questions to assess whether reform plans would continue to fulfill them:

- **Does reform keep Social Security mandatory?** The government has a legitimate interest in seeing that people do not under-save during their working lives and become reliant on the safety net in retirement. Moving toward personal ownership need not and should not mean "privatizing" Social Security. Any new personal accounts should be a mandatory part of the Social Security system. Choice is not important in a compulsory social insurance program whose primary function is to protect people against poor choices.

- **Does reform preserve Social Security's full range of insurance protection?** Social Security does more than write checks to retirees. It also pays benefits to disabled workers, widows, widowers, and surviving children. A reformed system should continue to provide insurance protection that is at least equal to what the current system offers.

- **Does reform maintain Social Security's progressivity?** While individual equity ("moneysworth") is important, so too is social adequacy. Social Security's current benefit formula is designed so that benefits replace a higher share of wages for low-earning workers than for high-earning ones. Under any reform plan, total benefits, including benefits from personal accounts, should remain as progressive as they are today.

- **Does reform protect participants against undue risk?** Under the current system, workers face the risk that future Congresses will default on today's unfunded pay-as-you-go benefit promises. While reducing this "political risk," personal account reforms should be careful to minimize other kinds of risk, such as investment risk, inflation risk, and longevity risk--that is, the risk of outliving ones assets.

Any genuine reform has a fiscal and political price, so it's tempting to pretend that the status quo can continue indefinitely. It can't. Today's Social Security system promises far more in future benefits than it can possibly deliver. Because of this, the proper comparison for any reform plan is between the benefits payable under a reformed system and the benefits payable under the status quo. No realistic reform plan looks good when compared to the false hypothetical of a perfectly solvent system. It is fundamentally unfair to judge any reform plan against a standard that assumes the current system can deliver everything it promises.

Moreover, in assessing the adequacy of benefits under a reformed system that includes personal accounts it must be kept in mind that a person's retirement income would come from *both* sources — a basic level of benefits from the defined benefit portion and the additional benefit financed from the lifetime accumulation of the personally owned account. In comparing benefit levels the entire benefit of a reformed system must be included.

Specific reform options that might do the job

Over the next 75 years, Social Security's revenues are projected to hover in a narrow range around 13 percent of the nation's taxable payrolls. The program's costs, on the other hand, are projected to grow rapidly from 11 percent of the nation's payrolls today to 15.5 percent in 2025 and more gradually thereafter to more than 18.7 percent by 2080.

While the conventional view is that those rising costs will be due to the aging of the population, that view is incomplete. A deliberate policy of paying ever-higher real benefits is also a significant factor. Thus, from a policy perspective, if the aim of reform is to address Social Security's financing problem at its source -- rising costs -- either adjusting the program for increasing longevity or constraining the growing value of its scheduled monthly benefits are the two most logical solutions.

The necessary savings could be achieved using some variation of the following options:

1. Raise the "normal retirement age" for full benefit eligibility

One of the most logical options to consider is raising the age for full benefit eligibility. It makes good sense for two reasons:

- Longevity is increasing steadily, and longer life spans mean longer, and more costly, benefit spans.

- In coming decades, the pool of working-age Americans will virtually stop growing, depriving our nation of this engine of economic growth. Raising the full benefit-eligibility age could help augment the labor force by encouraging older people to remain at work for a few more years.

It's conventional wisdom that our population soon will be growing older because the huge baby boom generation is poised to begin retiring. But that's only part of the picture. The problem posed by an aging population is not just that benefit spans will lengthen. We also expect to be coping with a labor shortage. Instead of increasing our supply of working age people by 2 percent each year as in recent decades, or even the current 1.5 percent rate today, between 2010 and 2050, workforce growth will slow to a crawl: just 0.3 percent per year.[1]

Growing our economy could help finance benefits for a mushrooming retiree population. But, boiled down to essentials, economic growth depends on two factors: increasing the number of workers, and increasing how productive each worker is. Since no one has a sure-fire recipe for boosting worker productivity enough to make up for the slowdown in workforce growth, anything we can do to encourage people to work a few more years and encourage employers to accommodate older workers will help our economy.

2. Index for Longevity

Any reform plan should also index initial benefits to changes in elder life expectancy. Without this provision, Social Security will once again drift out of balance; with it, the system's long-term cost will be stabilized relative to worker payroll.

Social Security retirement benefits are paid in the form of a defined benefit annuity. An annuity purchased with a defined contribution personal account balance would naturally take into account expectations about future longevity. The more years the annuity provider expects to have to pay benefits, the smaller the annual benefit a given account balance would buy. The current Social Security system makes no such adjustment. The benefit annuity it promises is set by a formula that yields the same result no matter how fast and far life expectancy rises. Cutting benefits by a fixed percentage may balance the system for a while. But unless reform also adjusts benefits for ongoing gains in life expectancy, the system will drift out of balance again.

3. Change the formula for determining initial benefits

a. Bend points

The determination of a retiree's initial Social Security benefit check is based on the calculation of Averaged Indexed Monthly Earnings (AIME). The amount of money earned by an individual each year of work is multiplied by the increase in average wages that has occurred up to the year of eligibility for Social Security, and then the average of the highest 35 years (fewer for those receiving disability benefits) of indexed wages is taken and divided by 12 to get the AIME.

Once the AIME is calculated, the Primary Insurance Amount (PIA) is determined by applying the "primary insurance amount formula." This progressive formula is designed to replace a share of annual pre-retirement income based on three "bend points." (90 percent, 32 percent, and 15 percent.) For example, in 2007 the replacement rates are 90

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[1] Social Security 2006 Trustees Report, Table V.B2, Additional Economic Factors.

percent of the first $680 of average monthly earnings, 32 percent for earnings up to $4,100, and 15 percent of higher earnings up to the taxable maximum.

One way to reduce Social Security's long-term cost would be to lower the bend points across the board. Or if preferred, reduce the replacement rate within each bend point bracket on a progressive basis that would protect low-income workers. This later approach would work particularly well with a system of personal accounts, which in the absence of some other mechanism such as savings matches paid out of general revenues, would make the overall system less progressive than it is now.

b. Price-indexing

Another option would be to index initial benefits to the growth in prices (CPI) rather than to the growth in wages. Under current law, initial benefit awards are indexed to wages--that is, the wage history on which benefits are based is updated at the time of retirement to reflect the rise in the economy's overall wage level over the course of the beneficiary's working career.

In effect, wage-indexing ensures that the living standard of retirees keeps pace with society's overall living standard. Re-indexing initial benefit awards to prices merely ensures that the absolute purchasing power of retirees keeps up with inflation. Note that this reform effects only initial benefit awards; current benefits are already price indexed.

The reform has two advantages: its simplicity and its large savings. If real wages are growing 1 percent per year faster than inflation, price indexing will result in a roughly 35 percent cut in initial benefits relative to current law for the first cohort to spend a complete career under the new regime. Under this assumption, the savings would be roughly sufficient to close Social Security's long-term cash deficit.

Under current law, it is virtually impossible to close Social Security's deficit through an acceleration in productivity growth. Higher productivity would result in higher wages and this would boost payroll tax revenue. But higher wages would also result in higher benefits, and this would largely cancel out the gain. With price-indexing, however, benefits would shrink indefinitely relative to taxable payroll and GDP — and the faster wages grow, the more benefits would shrink as a share of the economy.

This dynamic, of course, means that the living standards of retirees will diverge from those of the working population. To the extent that we view Social Security as a pure floor of projection, this does not pose a public policy problem. To the extent that we view it as an income replacement program, it does.

For this reason, price-indexing makes most sense as part of an overall reform that also incorporates funded benefits like personal accounts. The price indexed pay-as-you-go benefit would ensure that the purchasing power of benefits would remain the same for each new generation of retirees. The funded benefits would help ensure that the relative living standard of retirees is not eroded. The rate of return to a funded system, after all, is the rate of return to capital and historically, this has been faster than the rate of growth in wages.

4. Treat Social Security Benefits Like Private Pensions for Tax Purposes

Making 85 percent of all benefits taxable is fair, and should be on the table as a means of increasing Social Security's revenues. The 85 percent taxability rule that now applies to beneficiaries with incomes over high thresholds could apply to all beneficiaries. The 15 percent exemption reflects an estimate of the dollar value of most beneficiaries' prior FICA contributions that have already been subject to personal taxation. It would thus bring the tax treatment of Social Security in line with the tax treatment of private pension benefits.

Since this provision would affect only those households with enough income to pay income taxes, it would maintain the progressivity of the program. It's worth noting that because current law does not index the thresholds at which benefit taxation applies, a rising share of total OASDI benefits are now becoming taxable--and eventually 85 percent of all benefits will be taxable. Full benefit taxation is therefore already due to be instituted in the future (and future revenues from it are already included in current projections). What this option would do is to move to full benefit taxation right away.

The new revenue from this provision is not large but it is available immediately and thus generates critical near-term budget savings, which may be needed for the transition costs of any reform plan.

5. Affluence test

An affluence test for upper income beneficiaries could be designed as an alternative to full benefit taxation and generate roughly the same aggregate savings in every future year, which makes the two provisions substitutable. The appeal of full benefit taxation is its simple equity: It would merely subject Social Security beneficiaries to the same tax code as everyone else. The possible drawback is that it reaches deep down into the middle class. The appeal of the affluence test is its greater progressivity. The possible drawback is that it may be regarded as arbitrary.

6. Tax options

Raising future taxes is certainly a substantive option, and one that is more fiscally responsible than unlimited borrowing, but it ignores or dismisses the magnitude of the looming demands that Social Security and other entitlements will place on the income of future workers. Levying higher taxes to meet those costs could hinder an economy that will also have to cope with near stagnant workforce growth.

Yet even assuming that future workers will be able to afford higher taxes, there is another more fundamental reason why this should not be the first option for reform -- it is generationally inequitable.

Ultimately, choosing to raise future taxes to meet current law costs is similar to borrowing in that it places a claim on the expected earnings of today's children -- in effect confiscating their economic progress. If future generations want to sustain these higher costs it should be their choice, not the consequence of the current generation's refusal to plan responsibly for a known problem.

Financing current law benefit promises, for Social Security, Medicare and Medicaid would add about 8 percent of GDP to the federal tax burden by 2040 even under conservative assumptions. Will the American public in the future accept a permanent level of taxation that is 40 to 50 percent higher than it has been over the past 40 years?

Maybe it will, but there is no guarantee. Thus, aside from the dubious generational ethics of deciding today how our children should spend their money, relying on tax increases to fund current law benefit promises risks an intractable political dilemma for future lawmakers -- choosing between unacceptable tax levels or abrupt benefit cuts.

Some advocate getting the wealthy to contribute more by raising, or eliminating, the payroll tax cap on wages, now at $97,500. A modest increase in the wage base would bring in a modest amount of new revenue, but wouldn't do much to reduce the system's long-term cash deficit. Eliminating the cap would have a bigger impact, but would substantially alter Social Security's traditional focus on both fairness to individuals and protection of the needy. It would destroy the whole presumption of a contributory system--that what people get back be at least somewhat proportional to what they pay in.

Payroll tax increases should only be considered within the context of a comprehensive plan that lowers long-term costs. Higher revenues today will do nothing to lessen Social Security's future burden without a mechanism to ensure that the extra money is translated into higher savings and a larger future economy rather than higher spending on current government programs.

7. Personal account options

One potential mechanism for devoting higher contributions to new savings would be the creation of personally owned accounts within the Social Security system. This reform has could increase savings by providing a more reliable method of pre-funding benefit promises than government trust funds. It would provide a lockbox no politician could pick.

The current system provides a *statutory* right to benefits that Congress can cut at some future date. Personally owned accounts would offer workers ownership of constitutionally protected property. The funds would be put beyond the reach of government. Congress could not double-count personal account assets in the budget.

However, personal accounts are not a free lunch. Money to fund them must come from somewhere. To the extent that the source of funding is additional government borrowing, no new savings for the economy will result because the increase in government borrowing would cancel out the "savings" in personal accounts. Without new savings, any gain for the Social Security system must come at the expense of the rest of the budget, the economy, and future generations.

Moreover, individual accounts alone do nothing to close the existing gap between dedicated revenues and promised benefits. In any true transition to a funded system, workers will have to pay more, retirees will have to receive less, or both. Reform plans that do not face up to this transition cost will not result in new net saving or a larger economy.

Personal account reforms come in two basic types: "carve outs" and "add ons." In a carve out, a portion of the current payroll tax would be diverted to personal accounts. For the carve out to result in genuine funding, the diversion must be paid for by reductions in pay-as-you-go benefits beyond those that would need to be made in any case simply to eliminate Social Security's projected cash deficits. In an add on, the accounts would be funded partly or wholly from additional worker contributions. The contributions would be personally owned savings, and so would not constitute a tax--or at least would not function like one.

A pure carve out necessarily entails cuts in current-law Social Security benefits. Because personal account contributions would earn a higher return than contributions to the existing system, a carve-out plan might be able to pay retirees higher total benefits than today's purely pay-as-you-go system can afford. However, it cannot guarantee that retirees will receive everything that the existing system promises. In practice, most personal account carve outs rely on borrowing to substitute for the lost FICA revenue and mitigate benefit cuts. To be sure, reform plans that rely on debt financing usually promise that the debt will be paid back. But in most plans the borrowing is so large and the payback is so distant that it doubtful the payback will ever occur.

The "add on" approach offers a way to ensure the adequacy of future benefits without recourse to budgetary shell games. In fact, with a 2 percent of payroll add on it may be possible to ensure that every cohort of workers will receive benefits at least as large as what current law now promises but cannot afford. Is it worth paying a bit more to achieve these superior results? In the end, after all the shell games are played out, this is the central choice that the American public must confront.

To be clear, current law must eventually result in either a cut in benefits or a hike in taxes. If the choice is to avoid any hike in the Social Security contribution rate, a personal accounts carve out might generate larger benefits than today's pay-as-you-go system can afford. If the choice is to avoid any reduction in promised benefits, an add on might allow for this at a lower ultimate contribution rate. It is impossible to have it both ways: no cuts in total benefits and no new contributions.

Transitioning out of the current pay-as-you-go system into a partially funded system, with or without personally owned accounts, inevitably requires some group of workers to pay for the pre-funding of the new system while at the same time maintaining funding for those still receiving benefits under the old system. There is no avoiding this cost. Workers will thus have to save more, retirees will have to receive less, or both.

B. Medicare reform

Medicare is in worse shape than Social Security. We must engage on a bipartisan basis to make Medicare both effective and affordable over the long-term.

As currently structured, Medicare is financially unsustainable. Costs are growing faster than the payroll taxes and premiums that finance the program. Costs are also growing faster than the overall economy, and faster than can be reasonably supported by the federal budget unless spending priorities change dramatically.

Restraining the cost of the health care entitlements poses a greater challenge for policymakers than Social Security because the cost of delivering health care benefits is much more difficult to predict and control than simply providing cash benefits.

Health care costs are rising faster than wages. Consequently, the payroll taxes that fund Medicare are falling short of program costs. At the same time, the number of beneficiaries will climb steeply when the baby boom generation begins receiving benefits in 2011. Moreover, people who reach age 65 are living longer. People aged 85 and older are the fastest growing segment of our population. Medicare spending averages more than twice as much for people over 85 as it does for those age 65.

The addition of Medicare's prescription drug benefit merely compounded the program's shaky financial foundation. According to the Congressional Budget Office, the prescription drug benefit will have a net cost of $42 billion in FY 2008 and $270 billion over the next five years. More importantly, estimates indicate that the future obligations of the Medicare Part D drug benefit are roughly 50 percent more than those of the entire Social Security program. Congress and the President must look for ways to make the benefit more efficient, better targeted and less expensive.

Putting the Medicare program on a financially sustainable path will require some combination of reductions in services, increased cost-sharing by beneficiaries, increasing the eligibility age, bringing more revenues into the system and improving the cost effectiveness of Medicare and the health care system overall. We cannot pretend that there are simple fixes that don't require anyone to give anything up such as clamping down on fraud, or cutting back on excessive paperwork, or eliminating all the unnecessary tests and procedures. Pure "waste" is no easier to pinpoint in the health system than it is in the federal budget. And even if we could identify and eliminate all of it, the underlying cost drivers — from technology to expectations to aging — would soon cause spending to grow again as fast or faster than before.

Health care spending on the elderly will continue to grow faster than the economy so long as we pretend that costs can be controlled without any sacrifice. Costs aren't rising because of the proliferation of useless medical services. They're rising because medical science can do more for more people--and because what it can do is often very expensive.

Ultimately our nation must decide what level of health care we wish to provide, and how much we are willing to pay for it. A distinction must be drawn between wants and needs. Treatments that have little or no promise of achieving any appreciable improvement in a patient's well-being should not be financed with taxpayer dollars.

Setting limits in Medicare will mean moving toward a whole new paradigm--one in which prospective budgets at the program level and capitation at the beneficiary level finally compel us to make tradeoffs between health care and other national priorities.

Before thinking about specific ways to address the Medicare problem, it is important to establish a set of criteria against which various proposals can be evaluated. Listed below are the criteria that the Concord Coalition believes should guide decision makers in reforming Medicare.

- Quality care: Medicare insurance should cover a level of care that is commensurate with the care available to working age people. This does not mean that taxpayers must be expected to finance a "high option" insurance plan for all seniors. If individuals wish to purchase supplementary insurance to augment their Medicare benefits, they should be permitted to do so. However, there must be an affordable insurance plan to provide a reasonable level of medical care available to the elderly, regardless of their ability to pay.

- Fiscally responsible and generationally sustainable: No generation should have an automatic claim on taxpayer resources simply because of its chronological age. People of all ages have problems that the government could address, ranging from prenatal care, to child development and education, to job training, to old age assistance. A fiscally responsible program is one that can reasonably be expected to operate within the resources available to finance it. A program that assumes a perpetually open spigot from the Treasury gushing an ever-increasing flow of spending is not fiscally responsible. If it is decided that program costs should be permitted to increase, (i.e., filling the "donut hole" or adding long-term care) then fiscal responsibility demands that a commensurate stream of revenue be identified to pay for the program.

- Income-related cost sharing: As a group, seniors enjoy a better income and less poverty than other age groups, particularly children. Therefore, Medicare's medical insurance premiums should be geared to income levels.

- Efficient provision of medical care: Whatever new system of medical insurance for the elderly is devised, it should contain incentives for both providers and patients to use resources in a cost-effective manner. Treatments that have little or no promise of achieving any appreciable improvement in a patient's well-being should not be financed with taxpayer dollars. A distinction must be drawn between wants and needs.

- Prompt action: Changes in Medicare should be enacted promptly. Entitlement programs for the elderly are long-term commitments between the government and the citizenry. People base their behavior and make their plans based on current provisions. Therefore changes in the Medicare health insurance commitment should be undertaken in time to permit gradual changes and give people time to plan and adjust.

- Medicare changes should not be made in a vacuum: Medicare is only one of the long-term commitments citizens have made to support seniors, along with Social Security and, in the case of long-term care, Medicaid. When program reforms are considered one at a time, it is possible to ignore the ripple effect of changes in the cost or financing for other programs serving the elderly. And once a stream of revenues has been committed to pay for one of the programs on which elderly people rely, it can no longer be used to shore up other programs.

IV. Ensure an adequate revenue stream

Low taxes encourage economic growth by providing incentives for work, saving and investment. Tax policy, however, should not be considered in isolation. If taxes fall too far below spending for too long, the resulting deficits will eventually cancel out whatever positive effect there may be from low taxes. In the final analysis, revenues must be sufficient to pay for the cost of government. Debt is not a painless alternative to taxation.

While reforms should be enacted that would substantially reduce the long-term growth in federal spending, it is unlikely that any realistic array of reforms will allow an aging society to hold spending to today's level. Economic efficiency requires that taxes be held relatively stable at a level sufficient to pay for public spending in all future years, regardless of whether this leads to surpluses or deficits in any given year. It makes no sense to cut taxes today if that cut will only necessitate raising taxes tomorrow.

In that regard, The Concord Coalition believes that tax cuts scheduled to expire should not be permanently extended absent a plan for long-term fiscal sustainability.

Circumstances have changed dramatically since the bulk of the tax cuts were enacted in 2001. The surplus era in which the tax cuts were enacted has been replaced by deficits and the budget faces new demands for the war on terrorism and homeland security. Moreover, no action has been taken to prepare for the costs of the baby boomers' retirement and health care needs that will begin to place a growing strain on the budget in the years ahead. In fact, the burden has been dramatically increased with the addition of a Medicare prescription drug benefit. In light of all of this, it makes sense to reassess whether we should continue all of the tax cuts enacted in the surplus era.

It has been suggested that the recent high increase in the growth rate of federal taxes proves that tax cuts have not increased the deficit because they "pay for themselves" through greater economic growth. This is a tempting theory but it is not supported by evidence. Economists from the left and right generally agree that tax cuts do not fully pay for themselves through greater economic growth. A July 2006 analysis by the U.S. Treasury Department suggested that the economic feedback from extending the 2001 and 2003 tax cuts would offset less than ten percent of the revenue loss, and would only do so if the tax cuts were offset by spending cuts, something that has neither happened nor been proposed.

Revenue growth has indeed been very impressive over the past two years, however we should not leap to the conclusion that tax cuts lead to "higher" revenue. Keep in mind:

- While 2006 revenues ($2.4 trillion) set a record in dollar terms, it represents a much lower percentage of the economy (GDP) than in 2000 — 18.4 percent of GDP as opposed to 20.9 percent.

- Revenues in 2006 were almost identical to 2000 revenues adjusted for inflation. In 2000, revenues were 2.025 trillion. In 2006, revenues were $2.4 trillion, which translates to $2.029 trillion in 2000 dollars adjusted by CPI. Done in reverse, 2000 revenues would be $2.397 trillion adjusted for inflation.

- Individual income taxes are still below 2000 levels, adjusted for inflation. In 2006 individual income taxes totaled $1.04 trillion, which translates to $894 billion in 2000 dollars, well below the $1.004 billion in individual income taxes collected in 2000. If individual income taxes had kept pace with inflation since 2000, they would be $1.189 trillion. As a percentage of GDP individual income taxes have declined from 10.3 percent in 2000 to 8 percent in 2006.

- The $2.65 trillion of spending in 2006 is also a record in dollar terms, although as a percentage of the economy spending is actually a bit lower than its average over the past 40 year (20.3% in 2006 vs. the average of 20.6%)

Setting a record for revenues in nominal dollars is not remarkable. Revenues almost always set a record in nominal dollars every year as revenues naturally increase with inflation, economic growth and other factors. What is remarkable is that the revenue record set in 2000 ($2 trillion) was not broken until 2005. Between 2001 and 2003 revenues actually declined for three years in a row for the first time since the 1920's.

Moreover, there is not an inevitable connection between tax cuts, economic growth and higher revenues. For example, in the five years following the tax increases of 1993, annual real economic growth averaged 3.8 percent. In the five years since the tax cut policies began in 2001, annual real economic growth has averaged 3.1 percent. Certainly, this does not establish that tax increases are better for the economy than tax cuts, but it does establish that tax cuts enacted over the past few years are not necessarily needed beyond their expiration date to ensure economic growth.

If the decision is made to continue the expiring tax cuts, in part or in whole, Congress should look for options to fill the gap. To that end, there are other areas of tax policy that warrant consideration:

- **Raise excise taxes.** A higher gas tax increase would reduce U.S. dependence on foreign oil and encourage faster adoption of alternative fuel technology. Higher alcohol and tobacco taxes would discourage use especially among price-sensitive teenagers and young adults when these habits are most likely to form.

- **Tax excess employer-paid health insurance**. Employees do not pay income tax on the value of health insurance paid for by their employers. This coverage is received as part of their compensation along with pay and other benefits. According to the Government Accountability Office (GAO), this exclusion from income tax is the largest "tax expenditure." Very expensive policies cover most or all of a wide range of medical and related services, leaving employees with few, if any, out-of-pocket costs. Therefore, they have little cost consciousness in choosing the type of health care services they use. The President has proposed to end this exclusion, although the initial savings would be used for new health insurance deductions and exclusions.

- **Limit the home mortgage deduction.** The tax-favored status of home ownership distorts investment decisions by encouraging Americans to place a disproportionate share of their savings into a home rather than other higher-yield, more productive assets like plant, equipment, education, and training.

- **Impose a Consumption tax.** By removing the disincentives to save, a consumption tax would increase the nation's pool of savings so that funds will be available for investment and economic growth.

Spending restraint is, of course, the key to maintaining a sustainable fiscal policy and allowing future generations more of a choice in setting their own priorities. But experience has demonstrated that attempting to reduce spending simply by cutting taxes, or "starving the beast," is a failed strategy.

The tax burden is ultimately determined by the government's spending commitments and not the other way around. Whatever government spends, it must eventually pay for. Deficits merely shift the tax burden toward the future, while surpluses shift it toward the present. Unless we reduce spending over the long-term we are not really cutting taxes over the long-term but merely shifting the tax burden from ourselves to our children. The best fiscal policy is one that aims to prevent total spending, taxes or debt from reaching levels that could reduce economic growth and future standards of living.

V. Improve the budget process

Budget rules alone will never be able to solve the nation's fiscal problems, however, enforcement mechanisms can bring greater accountability to the budget process and help provide Members of Congress with the political cover to make the tough choices necessary to reduce the deficit. Pay-as-you-go rules (PAYGO) for all tax and entitlement legislation and spending caps for appropriations are proven tools for fiscal discipline. These enforcement rules, enacted in 1990 and extended in 1997 with bipartisan support, were an important part of getting a handle on the deficits in the early 1990s and getting the budget back into balance. The lesson to be learned from the overall success of the BEA is that budget process can be an important tool in achieving strategic long-term goals. Unfortunately, Congress allowed these rules to expire in 2002.

The Concord Coalition strongly supports a pay-as-you-go (paygo) rule in the House and Senate requiring entitlement expansions and tax cuts to be offset by corresponding spending cuts or revenue increases. We believe that reinstating paygo in this form, as it was originally designed, is a crucial step toward restoring fiscal discipline and preventing the daunting long-term outlook from getting any worse. We also hope that it will encourage a discussion of the tough choices that must be made, regardless of procedural mechanisms, to restore fiscal responsibility.

No budget rules will be effective, however, if they are not accompanied by a commitment to enforce them. Thus, it is critical that Congress resist the pressure to weaken them by exempting politically popular items, assuming additional costs in the baseline or routinely circumventing them when they become inconvenient. This will require policymakers to set priorities and make compromises among competing needs. Many tax and spending initiatives will need to be scaled back to fit within the amount of available offsets.

Some have argued that paygo should only apply to spending increases and not tax cuts. This would be a mistake. Fiscal discipline is a concept that applies to the budget as a whole. Any legislation that would increase the deficit should be part of the enforcement mechanisms. Since spending and tax decisions both impact the bottom line, there is no good reason to exempt either from enforcement rules. Moreover, exempting tax cuts from paygo would encourage an expansion of so-called "tax entitlements" where benefits are funneled through the tax code rather than by direct spending. Finally, exempting tax cuts from paygo encourages the false notion that debt is a painless alternative to taxes.

Adoption of a paygo rules in the House a and Senate should be followed by enactment of legislation reinstating the Budget Enforcement Act in its original and successful form, including statutory paygo and limits on discretionary spending enforced by sequestration. Reinstating statutory paygo will put additional teeth into the paygo rule by establishing a mechanism that cannot be easily waived or repealed by a future Congress. Budget enforcement rules should apply to all parts of the budget — taxes, entitlements and discretionary appropriations. Excluding any part of the budget from discipline will inevitably lead to that part of the budget becoming the escape valve for budget busting proposals.

Ideally, a new bipartisan balanced budget plan should be agreed upon and enacted along with strong enforcement mechanisms. But the fact that more needs to be done is not an excuse for doing nothing. The choice for policymakers is whether to reclaim a measure of fiscal discipline through the budget process while a more substantive plan is negotiated, or to sit by while deficits drift higher in the absence of any procedural hurdles designed to rein them in.

In Concord's view the choice is clear. We believe that reinstating strong budget enforcement rules, such as paygo, is the best step that can be taken immediately to stop digging the fiscal hole deeper.

While this would be a positive step, it falls short of addressing the central long-term budget challenge, which is constraining the cost of existing entitlement programs. Paygo requires Congress to offset the cost of new programs or expansions of existing programs. It does not apply to current-law benefits.

In fact, there is nothing in the budget process that requires Congress to review the current-law budget outlook beyond the next ten years, much less take corrective action. Every corporation in America must account for and defray the cost of its long-term commitments. But the federal government does not, even though its commitments are thousands of times larger than those of any corporation.

The current budget process encourages short-term thinking by focusing on a 5 or 10-year window. Yet, as analysts from all sides generally agree, our truly unsustainable fiscal problem stems from commitments that extend far into the future. You could take a major step in improving the transparency of our future obligations and encourage actions to deal with them by including in the budget resolution targets and estimates of your policy proposals stretching out for at least 40 years.

A five or ten year budget window may have been adequate back when most federal spending was appropriated annually. It is insufficient when most of the budget consists of entitlement programs set on a rising autopilot. It's time to include the long term in the budget process.

Congress should establish long-term targets for revenues and outlays by major spending category as part of the annual budget resolution. It should note how major legislative proposals assumed in the resolution would affect these targets and how the targets differ, if at all, from current law as projected by the CBO. Separate targets could be established, as a share of GDP at five-year intervals through 2040, for total revenues, defense spending, domestic discretionary spending, Social Security, Medicare, Medicaid, other entitlements, and net interest. If the targets differ from current-law projections, CBO could be required to issue a report with an illustrative menu of reform options capable of generating the proposed savings. [2]

Compelling Congress to go on record about its long-term budget priorities, would focus the public (and Congress itself) on the nature of the choices before us—and so might pave the way for lasting reform.

To be sure, this proposed reform would not actually compel Congress to raise a dime in taxes or cut a dime in spending. But then again, neither would the other reforms. Automatic triggers usually lead to fiscal shenanigans, not fiscal discipline. What's worse, they send the wrong signal. What we need is strategic vision, not arbitrary mechanisms. No Congress will ever enact an entitlement cut that it has not debated and for which the public is not prepared.

By contrast, this proposal would inject strategic vision into the budget process. Those who want to leave taxes alone would have to propose large entitlement cuts. Likewise, those who want to leave entitlements alone would have to propose large tax hikes. Without some mechanism is put such choices on the record everyone can continue to ignore the long-term consequences of current policy. With it, they must begin to talk concretely about the size and shape of the government they want. Meanwhile, the CBO reform options would educate the public about the practical steps needed to get there.

VI. Establish a bipartisan process

Since the regular legislative process has been incapable of dealing with the impending fiscal crisis, some have suggested that a new bipartisan commission be appointed. This could be a useful mechanism to break the gridlock, but only if it recognizes fiscal and political realities. As Concord Co-Chairs former Senators Warren Rudman (R-NH) and Bob Kerrey (D-NE) wrote in a *Washington Post* op-ed, the commission would need five elements to succeed:

- First, it must be truly bipartisan. Any perception that the commission's purpose is to facilitate swift enactment of a partisan agenda would doom it to failure. It must have bipartisan co-chairs and equal representation. Doing otherwise in the current partisan environment would be a waste of time and money.

- Second, it must have a broad mandate. While it is critical to control the growth of entitlements, particularly Medicare and Social Security, the commission should examine all aspects of fiscal policy.

- Third, all options must be on the table. If either side sets preconditions, the other side will not participate. This means that Republicans cannot take tax increases off the table and Democrats cannot take benefit reductions off the table.

[2] See, Concord Coalition Facing Facts Quarterly, December 2006, "Beyond Paygo: How to Encourage Long-Term Fiscal Discipline," by Richard Jackson.

- Fourth, the commission must engage the public in a genuine dialogue about the trade-offs inherent in realistic solutions. When people are armed with the facts and given the opportunity for honest dialogue, they are willing to set priorities and make hard choices.

- Fifth, the commission's recommendations should be given an up or down vote in Congress, allowing for amendments that would not reduce the total savings. Absent that, the report would likely join many others on a shelf.

In the ideal world, we would not need another commission to tell us things most people in Washington already know. Moreover, as the Chairman and Ranking Member of this Committee have reminded everyone, elected leaders — not an appointed commission — must make the ultimate decisions. However, a commission with a broad mandate and no preconditions could develop a credible marker for Congress and the President. In any event, the conditions for success noted above by Senators Rudman and Kerrey apply equally to a direct negotiation among lawmakers as they do to a commission.

VII. The importance of public engagement

Political realities explain why nothing has been done. Changing course will require substantial spending reductions from projected levels, equivalent increases in revenues, or — most likely — a combination of both. Neither party wants to be the first to propose such tough choices out of fear that the other side will attack them. Similarly, neither side wants to discuss possible compromises of their own priorities out of fear that the other side will take the concessions and run. Unfortunately, these fears are justified.

Because these choices are politically difficult, the active involvement of the American people is critical. Without greater understanding of the problem among the public, community leaders, business leaders and home state media, elected leaders are unlikely to break out of their comfortable partisan talking points — and unlikely to find solutions.

The Fiscal Wake-Up Tour is a joint public awareness initiative by The Concord Coalition, the Budgeting for National Priorities Project at The Brookings Institution, and The Heritage Foundation. U. S. Comptroller General David Walker is an advisor and has participated in each of the Tour's public events.

For the past year we have visited many cities including Atlanta, Richmond, Minneapolis, Portland (OR), Kansas City, Durham, Omaha, Philadelphia, Wilmington, San Diego, Austin, Chicago, Denver, Seattle and Columbus. We have also spoken to various organizations such as the National Conference of State Legislatures and the National Conference of Editorial Writers. Many other events are being planned for the fall and into next year. In fact, later today some of my Fiscal Wake-Up Tour colleagues and I will be headed to Iowa for a series of forums.

The purpose of this Tour is to explain in plain terms why budget analysts of diverse perspectives are increasingly alarmed by the nation's long-term fiscal outlook. Our emphasis is on the key areas in which we have found consensus, such as:

- The overall dimensions of the problem;
- The nature of the realistic trade-offs that must be confronted in finding solutions;
- The adverse and inequitable consequences for future generations if we fail to make serious changes, sooner rather than later.

Our mission is to cut through the usual partisan rhetoric and stimulate a more realistic public dialogue on what we want our nation's future to look like, along with the required trade-offs. We believe that elected leaders in Washington know there is a problem, but they are unlikely to act unless their constituents better understand the need for action, and indeed, demand it.

Members of the Fiscal Wake-Up Tour do not necessarily agree on the ideal levels of spending, taxes and debt, but we do agree on the following key points:

- Current fiscal policy is unsustainable.
- There are no free lunch solutions, such as cutting waste fraud and abuse or growing our way out of the problem.
- The best way to make the hard choices is through a bipartisan process with all options on the table.
- Public engagement and understanding is vital in finding solutions.
- This is not about numbers. It is a moral issue.

A typical stop on the Fiscal Wake-Up Tour will include a public forum, a breakfast meeting with community/business leaders and an editorial board meeting with the local newspaper. In most cases, the venue for the public forum is a college or university.

The program generally consists of presentations by four or five panelists and an extended Q&A session with the audience. Panelists use PowerPoint presentations to show:

- The current budget numbers in historic context as a percentage of GDP;
- Where the budget is headed on autopilot;
- The driving forces behind the long-term projections;

- The magnitude of the changes in either spending or tax policies that are needed to bring about a more sustainable and generationally equitable outcome;

- Potential consequences of failure to change course.

We do not recommend specific policy solutions. Indeed, we are upfront about the fact that we do not necessarily agree on solutions. However, we remind audiences that each of the realistic options comes with economic and political consequences that must be carefully weighed, and that there must be tradeoffs. Those who want to raise taxes are asked to explain what level of taxation they are willing to support and the manner in which the new revenue should be raised. Those who argue that spending must come down from projected levels are asked which programs they would target and how the savings would be achieved. Those who are unwilling to do either are asked how much debt they are willing to impose on future generations.

Our experience is that when audiences are told the facts, and shown that if they demand their "rights" to programs or policies it will have damaging economic effects to other groups or generations represented in the audience, they begin to accept the need for tradeoffs.

The Fiscal Wake-Up Tour does not presume to know the "correct" answers, but we are trying to make sure that the American people and their elected leaders are asking the correct questions.

In addition to the Fiscal Wake-Up Tour, the same group of analysts from The Concord Coalition, The Heritage Foundation and The Brookings Institution have been working with Public Agenda and ViewPoint Learning, (both chaired by Dan Yankelovich) on a project designed to provide insight into how attitudes evolve as people discuss difficult trade-offs with regard to long-term fiscal policy.

Three intensive day-long "Choice Dialogues" were conducted earlier this year in San Diego, Kansas City and Philadelphia. Public Agenda and ViewPoint Learning are in the process of reviewing the results. A report issued in December 2006 made the following observations:

- The public is strongly averse to big increases in the size of the national debt and, with the right kind of leadership, is prepared to accept sacrifices to avoid it.

- For most people, the overriding concern is not resistance to taxes but a profound lack of trust in government. People are willing to pay for what they want so long as they can be satisfied that government will spend the money wisely and for the purposes intended.

- Americans are willing to make changes in entitlements, but again on condition that trust and accountability exist.

- While there is continued strong support for defense spending, it is accompanied by the widespread perception that funds are misallocated and often wasted.

- Americans want to be engaged in addressing these issues and are frustrated by the lack of engagement that contributes to their mistrust of government

Daunting as the long-term projections are, there is nothing inevitable about a fiscal crisis. The problems we face -- essentially a structural imbalance between what government promises and what it collects in taxes to pay for those promises -- is one that can be cured in a timely way if we begin to address it now. In other words, the solution is in our own hands. As Concord Coalition President and former Commerce Secretary Peter G. Peterson has written in his 2004 book, *Running on Empty*:

> If America chooses the right future, it will be because we learn again to cooperate politically and embrace a positive vision of what our nation can become. Yes, we have to make some tough choices. But instead of obsessing over the tax hike that outrages us, or the benefit cut that shocks us, we need to focus on everything our nation can achieve if we all made an effort to come to terms with our future.

There is no better time to begin such an effort than now. The lessons of Hurricane Katrina have important implications for our long-term fiscal challenge. Known dangers should be acknowledged in advance of a crisis and dealt with in a straightforward manner. By all means, we should debate the options and trade-offs. But we must act. Economic growth alone will not be enough to close the gap. Moreover, the sooner action is taken, the more gradual the remedies can be. The political system can adjust to unexpected good news. More problematic are the potentially harsh adjustments of deferring action on bad news projections that prove correct.

Concord's founding Co-Chair former Senator Paul Tsongas (D-MA) said, "The bond between parent and child is nature's strongest. Providing for the well-being of the young is how every generation of Americans undertook their stewardship."

Our time to act as generational stewards is now.

THE CONCORD COALITION

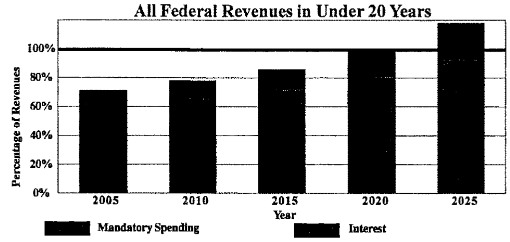
AN OPEN LETTER TO THE PRESIDENT AND CONGRESS:

THE AMERICAN PEOPLE CAN HANDLE THE TRUTH. WILL YOU?

The most important message the American people sent to their elected leaders last November was the desire for change. Americans want a new direction and bipartisan cooperation on a number of fronts, including fiscal policy. The Concord Coalition strongly urges you to heed this call — not for political advantage, but as your stewardship responsibility to future generations.

We believe the direction of current fiscal policy is dangerous. Chronic heavy borrowing is gradually weakening our long-term economic strength. Moreover, failure to address the vast unfunded obligations of Social Security and Medicare — $39 trillion at last count — risks a generational conflict in which the children of today's baby boomers will face the terrible choices of much higher taxes, dramatic cuts in their parents entitlement programs, greatly diminished ability to set their own spending priorities, or unsustainable debt.

Entitlements and Interest Are Projected to Consume All Federal Revenues in Under 20 Years



Source: Congressional Budget Office, December 2005, "The Long Term Budget Outlook, Scenario One

Generational fairness requires a major course correction. We recommend that the following four steps be taken immediately:

1. ***Restore budget caps and pay-as-you-go rules for new spending and tax cuts.*** These simple rules played a crucial role in bringing the deficit under control in the 1990's. Renewing them is the most important thing you can do in the short-term to prevent the long-term outlook from getting worse. However, the rules must not be weakened by exempting popular programs or circumventing them when they become inconvenient. The inconvenience is what makes them valuable.

2. ***Negotiate a bipartisan plan to balance the budget.*** We are encouraged that the President and the Democratic chairmen of the House and Senate Budget Committees have indicated their support for a balanced budget by 2012. Firm commitment to this goal will force tough choices among the countless proposals for increased spending and new or extended tax cuts that the new Congress will be bombarded with. Balancing the budget would also lower interest payments on the debt, reduce borrowing from abroad and boost national savings. To be meaningful, however, the plan must use realistic cost estimates for military operations, reform of the Alternative Minimum Tax (AMT), non-defense discretionary spending and all other matters. It must also be based on bipartisan negotiations.

3. ***Include long-term projections in the budget resolution.*** The impact that your decisions have on our children and grandchildren must be better understood. Yet, the current budget process encourages short-term thinking by focusing on a five or 10-year window. This timeframe is insufficient because it fails to recognize rapidly growing commitments for retirement and health care costs that extend far into the future. Spending and tax policies that may seem "affordable" over 10 years will seem far less so if viewed in the long-term context.

4. ***Begin a bipartisan process to address long-term fiscal challenges.*** The structural imbalance between future benefit promises and the revenues projected to pay for them must be addressed head-on. A realistic strategy will require reductions in promised benefits, higher revenues, or a combination of both. Everything must be on the table. Some have suggested a bipartisan commission to make recommendations, while others insist on direct negotiations between Congressional leaders and the administration. Either is acceptable, so long as it begins now and includes a broad mandate to consider all aspects of fiscal policy with no preconditions.

The Concord Coalition has been traveling the nation on a "Fiscal Wake-Up Tour" with Comptroller General of the United States David M. Walker and other experts of diverse perspectives. The message from these forums is clear: the American people understand the need for action and, with the right kind of leadership, are prepared to accept sacrifices. But you must convince them that you are serious and that any sacrifice they make will result in a brighter future, not more of the same. Don't let them down.

Hon. Warren B. Rudman
Former U.S. Senator
Co-Chairman

Hon. Peter G. Peterson
Former Secretary of Commerce
President

Hon. J. Robert Kerrey
Former U.S. Senator
Co-Chairman

Hon. Robert E. Rubin
Former Secretary of the Treasury
Director

Hon. Sam Nunn
Former U.S. Senator
Director

Hon. Paul A. Volcker
Former Chairman,
Federal Reserve Board
Director

Charles A. Bowsher
Former Comptroller General
of the United States
Director

Chairman CONRAD. Thank you very much, Mr. Bixby.

Dr. MINARIK. Welcome. Always good to have you. Please proceed.

STATEMENT OF DR. JOSEPH J. MINARIK, SENIOR VICE PRESIDENT AND DIRECTOR OF RESEARCH, COMMITTEE FOR ECONOMIC DEVELOPMENT

Mr. MINARIK. Thank you, Mr. Chairman, Senator Gregg, members of the committee.

Your committee's hearing record thus far has documented clearly that following the outlook of large and continuing budget deficits would be unwise and even dangerous. In addition, it is morally questionable.

Let me stipulate the committee's record and move on to address the exceedingly difficult question of how the Nation might cure these deficits.

To begin, however, let me make one point of transition between cause and cure. Some say today that tax cuts have made our economy strong and yielded a large revenue boost which will eventually pull the budget out of deficit. To this view I can only personally observe: been there, done that.

There was a similar, in fact far stronger, revenue boom in the 1990's following, ironically, a deficit reduction program of which about half was a tax increase. In retrospect, that revenue boom was driven in substantial part by extraordinary returns in financial markets. As seasoned financial market professionals will readily tell you, markets go up and markets go down. The revenue boom of the 1990's ended, and the current revenue boom will end as well.

Having watched all of this happen before at close range, I would urge you not to let temporary fluctuations in revenues delay sound long-term policymaking.

The Committee for Economic Development, CED, has considered the budget problem from virtually every angle. Let me provide our conclusions for your consideration, reviewing all of the major components of the budget.

Briefly, first, CED has called on the Congress to reinstate the budget disciplines from the 1990 bipartisan budget agreement. Let me congratulate this Congress for taking a long step forward on that issue, while urging a full statutory reenactment of these disciplines.

Second, the CED Trustees have urged the Congress and the Administration to seek out all possible opportunities to weed out waste and duplication in domestic appropriated spending and also in defense appropriations, which the current war effort obviously complicates. CED has also noted that we have no expectation that there will be nearly enough in discretionary savings to solve the long-term budget problem, especially in light of the national priorities that must be advanced through appropriations.

This leaves virtually the entire weight of deficit reduction on the remainder of the budget. One program mentioned currently as a possible subject of legislative action is Social Security. Because Social Security as currently configured is not sustainable in the long run, action is needed. Furthermore, the last major restructuring of Social Security, in 1983, significantly helped the unified budget and therefore the Federal Government's need to borrow from the public to fund its operations.

However, the kind of action now often contemplated, partial privatization, would make our overall budget predicament enormously worse. The simple reason, as Bob suggested, is that the current Social Security operating surplus, which is held by the Federal Treasury in cash and therefore reduces borrowing needs, would have to be diverted in significant measure to capitalize the individual accounts. That would constitute a net loss to the Treasury for decades.

There will be no benefit reduction savings from partial privatization for almost a decade and those savings will begin only very slowly while deposits into the private accounts must be made at full speed from the very beginning. As a result, the unified budget that is about to move into substantial deficit would add on even more debt.

It is of absolutely no consolation that the Social Security plan, taken on its own, would be actuarially sound over 75 years, or even longer. The Federal Government's finances would be dead long before then.

My own calculations of several years ago suggested that the Social Security partial privatization plan would not recover to a net break even for the unified budget for more than half a century. I know of no serious observer of the Federal budget, certainly not the President's own Office of Management and Budget, who would contend that the Federal Government's finances will remain healthy without serious restructuring much sooner than 50 years from now.

CED issued a statement on Social Security reform in 1997 which we reaffirmed in 2005. Specifically, we recommended gradual reductions in benefits that would yield permanent solvency for the system with a margin of safety in those calculations. The benefit reductions would include changes in the benefit formula, increases in both the normal retirement age and the age of earliest eligibility, and the income taxation of 100 percent of benefits.

To compensate for those benefit reductions, we would add private accounts. These private accounts would be mandatory and would be funded by contributions equal to 3 percent of covered payroll, 1.5 percent each from employer and employee. The contributions would belong to the employee and would be placed in purely private accounts, without being handled by the Federal Government. Again, these recommendations would leave Social Security permanently sustainable under current assumptions, would increase national savings, and would improve rather than deplete the unified budget.

Close observers of the Federal budget will be quick to note that the long-term budget problem is driven much more by health care costs than by Social Security. In fact, some might go so far as to characterize Social Security restructuring as mere batting practice before the real contest against rising health care costs.

Let me offer two cautionary notes with respect to health care costs. First, it is difficult to conceive of policies to cut the Federal Government's health care costs without restructuring the health care system as a whole. One could not imagine physicians under Medicare and under the private market practicing side-by-side for very long at significantly different and diverging reimbursement rates or levels of productivity.

Furthermore, our health care system is no more sustainable for private employers, who pick up the bill for much of the working age population and their dependents, than it is for the Federal Government, which is responsible for much of the bill for the elderly. Thus, to fix the health care system for the elderly, we almost certainly must fix it for everyone.

Second, it is hard to imagine a simple CBO-scoreable fix for Medicare or Medicaid short of a reduction of program coverage that would not be much less dramatic than offering the very ill only an icy lake and a canoe with no paddle. The Federal Government's experts already have learned that reductions of reimbursement rates of the depth that would be necessary to balance the system in the long run would elicit almost equally sharp increases in the volume of services provided, through which providers would attempt to maintain their incomes.

Moreover, such reimbursement reductions would not be sustainable in the context of our mixed public and private system. Large numbers of physicians simply would refuse to serve Medicare patients.

Therefore, to solve our impending Federal health cost crisis, we need a fundamental restructuring of the entire health care system along lines that will yield a qualitative, not just a measurable and quantitative, change in the way health care is delivered. CED looked at these issues in 2002 and we now conclude that we underestimated the magnitude of the structural change required. Accordingly, we are revisiting this issue now. We are starting with the employment-based health care system for working-aged persons and their dependents in a way that we believe will have important synergies with Federal programs for the elderly.

Although our deliberations are not yet complete, we have tentatively settled on a system that would give to the working age population a menu of choices similar to those available today to Federal workers under the Federal Employees Health Benefits Program, and to a few consortia of private employers around the country.

An independent Government agency, perhaps structured like the Federal Reserve Board of Governors, would play the regulatory role of the office of Personnel Management in the FEHBP including, for example, setting minimum standards for the insurance policies that are included in the menu. People would receive defined contributions such that everyone could obtain the low price plan that meets the appropriate standards, but those who want more expensive coverage would be responsible for the incremental cost out of their own pockets.

Beyond universal coverage, the goal of this approach would be to encourage consumers to be cost-conscious choosers of their health insurance plans rather than of individual medical services. We believe that giving consumers such cost conscious choices will drive both insurers and health care providers to improve efficiency so that they will be able to offer better services at lower prices and thereby attract more customers, just as other industries in the U.S. economy have learned to seek greater efficiencies so as to remain competitive.

Mr. Chairman, I am running over so I get to skip talking about taxes. I guess the only thing that I would note is that we should consider, when we are concerned about our tax burdens today, the implications of procrastination in dealing with the budget problem for the taxes that will be paid by our children and grandchildren in later years.

A large portion of the problem in the budget outlook is increases in the buildup of debt. We can forestall that by reducing budget deficits in the short term by any tool, even if we believe that the ultimate solutions to those problems are longer-term repairs for Medicare and Medicaid.

Finally, Mr. Chairman, I have to note my resentment that my friend over here, Mr. Bixby, mentioned the issue of grandchildren when he does not have any and I do.

Thank you and I look forward to your questions.

[Laughter.]

[The prepared statement of Mr. Minarik follows:]

Exploring Solutions To Our Long-Term Fiscal Challenges

Statement Of
Joseph J. Minarik
Senior Vice President And Director Of Research
The Committee For Economic Development
Before
The Committee On The Budget
United States Senate
January 31, 2007

Your Committee's hearing record thus far has documented clearly that following the current outlook of large and continuing budget deficits would be unwise, and even dangerous. The resulting unsustainable accumulation of debt and growing debt-service obligations would raise an ever-present possibility of short-term economic disruptions, and the certainty of a longer-term erosion of our standards of living. In addition, it is morally questionable to shift obligations from our current generation which has enjoyed levels of consumption higher than its income, to future generations which already face potentially costly challenges of our making (such as providing for our retirement and health care, and rectifying greenhouse gas buildups in the atmosphere). Let me stipulate the Committee's record (which we can discuss during questions if you should wish) and move on to address the exceedingly difficult question of how the nation might cure those deficits.

To begin, however, let me make one point of transition between cause and cure. Some say today that tax cuts have made our economy strong and yielded a large revenue boost, which will eventually pull the budget out of deficit. To this view I can only personally observe: Been there, done that. There was a similar, in fact far stronger, revenue boom in the 1990s, following, ironically, a deficit reduction program of which about half was a tax increase. (Incidentally, please note that in the current revenue "boom," nominal individual income tax revenues have only just in 2006 recovered their level of six years earlier, after a precipitous decline.) The economy in the 1990s grew as strongly as, or even more strongly than, the current economic expansion, with a stronger investment boom that laid the foundation for the subsequent increases in productivity and output. However, the rapid revenue growth of that period did not go on forever. In retrospect, it was driven in substantial part by the extraordinary returns in the financial markets at that time, through employee options and bonuses as well as realized capital gains. As seasoned financial market professionals will readily tell you, markets go up, and markets go down. The revenue boom of the 1990s ended, and the current revenue boom will end as well. The difference is that, in the absence of the tax cuts of 2001, the end of the 1990s revenue boom would have left the budget in approximate balance. The end of this revenue boom, in the absence of any future policy change, will drop the budget back into substantial and unsustainable deficit. Having watched all of this happen before at close range, I would urge you not to let temporary fluctuations in revenues delay sound long-term policymaking.

The Committee for Economic Development (CED) is an organization of leaders from the business sector, with a board of trustees numbering approximately 200. The board's Research and Policy Committee approves all CED policy statements by majority vote; trustees are free to register any comment or dissent. In keeping with our unchanged original mission to "improve[e] the growth and productivity of the U.S. economy," CED has considered the budget problem from virtually every angle. Let me provide our conclusions for your consideration, reviewing all of the major components of the budget.

Budget Disciplines

Briefly, first, CED has called on the Congress to reinstate the budget disciplines from the 1990 Bipartisan Budget Agreement, to provide standards of discipline to help to channel policy in a constructive direction. Let me congratulate this Congress for taking a long step forward on that issue, while urging that a full statutory reenactment of those disciplines, including discretionary spending caps and sequestration, would be even better.

Appropriations

Second, the CED trustees have urged the Congress and the Administration to seek out all possible opportunities to weed out waste and duplication in domestic appropriated spending (and also in defense appropriations, which the current war effort obviously complicates). CED has also noted that we have no expectation that there will be nearly enough in discretionary savings to solve the long-term budget problem, especially in light of the national priorities that must be advanced through appropriations. (For example, CED has championed the availability of universal preschool as an important economic investment.) So CED would view management of domestic appropriations as an important step to keep the budget under control, but not as a source of sufficient savings to eliminate the long-term deficit. This judgment would appear to be ratified by the developments of last year, when the Congress failed to enact any domestic appropriations bills (other than homeland security). Presumably, if the passage of significant discretionary spending cuts were feasible, that Congress would have done so, and would have touted that achievement to the electorate. The absence of action would seem to suggest that even the proposed cuts of last year, which would have been only the first slice of the action necessary to subdue the deficit, were and remain simply not viable.

Social Security

This leaves virtually the entire weight of deficit reduction on the remainder of the budget. One program mentioned currently as a possible subject of legislative action is Social Security. Because Social Security as currently configured is not sustainable in the long term, action is needed. Furthermore, the last major restructuring of Social Security, in 1983, helped the unified budget (and therefore reduced the federal government's need to borrow from the public to fund its operations) significantly.

However, the kind of action now often contemplated, partial privatization, would make our overall budget predicament enormously worse. The simple reason is that the current Social Security operating surplus, which is held by the federal Treasury in cash and therefore reduces borrowing needs, would have to be diverted in significant measure to capitalize the individual accounts. That would constitute a net loss to the Treasury for decades. The President, in his proposal for partial privatization, has maintained, very rightly, that those over 55 years of age should be able to receive Social Security benefits according to the current law. This is only fair, because older workers who already have begun to execute proximate plans for retirement cannot make substantial adjustments; they need fair warning of lower retirement benefits so that they can choose employment opportunities that will allow them to work longer, and so that they have time to save more on their own. However, this means that there will be no benefit-reduction savings from the President's plan for almost a decade, and those savings will begin only very slowly – while deposits into private accounts must be made at full speed from the very beginning. As a result, a unified budget that is about to move into substantial deficit would add on even more debt. It is of absolutely no consolation that the Social Security plan, taken on its own, would be actuarially sound over 75 years or even longer. The federal government's finances would be dead long before then.

To convey the shape of this problem, note that others have estimated that the President's plan would add $17.7 trillion to the public debt by 2050 – almost 20 percent of the projected GDP for that year, or an increment of more than half the level of the total debt today – and would increase annual debt-service costs in that year by 1.1 percent of projected 2050 GDP – or more than two-thirds of the amount of total interest costs in today's budget. The savings from reduced benefits would trail behind this added debt and debt-service. My own calculations of several years ago suggested that the Social Security partial privatization plan would not recover to a net break-even for the unified budget for more than half a century. I know of no serious observer of the federal budget, certainly not the President's own Office of Management and Budget (in its "Stewardship" chapter of the *Analytical Perspectives* volume of the Budget), who would contend that the federal government's finances will remain healthy without serious restructuring much sooner than 50 years from now. And yet Social Security privatization would add enormously to these problems. Clearly, anyone who believes that partial privatization is the right way to go must acknowledge that it would make the problems of the unified budget significantly worse, and would require far greater spending cuts and tax increases than otherwise to keep the debt from exploding.

CED issued a statement on Social Security reform in 1997, and we reaffirmed our position in 2005. We took the more conventional view seeking a Social Security reform that would improve, rather than weaken, the unified budget. Specifically, we recommended gradual reductions in benefits that would yield permanent solvency for the system, with a margin of safety in those calculations. The benefit reductions would include changes in the benefit formula, increases in both the normal retirement age and the age of earliest eligibility, and the income taxation of 100 percent of benefits. (A full description of the CED recommendations is available on our website, www.ced.org.) These reductions would of course leave benefits lower than they would be under current law, but higher in inflation-adjusted dollars than they are today. The reductions would be progressive in the sense that benefits would be reduced more for higher-wage beneficiaries. To compensate for these benefit reductions, we would add private accounts. These private accounts would be mandatory, and would be funded by contributions equal to 3.0 percent of covered payroll (1.5 percent each from employer and employee). The contributions would belong to the employee, and would be placed in purely private accounts, without being handled by the federal government. The CED trustees believed that this would give wage earners the best reason to be willing to make those contributions and to trust in the system and the process.

Again, these recommendations would leave the Social Security system permanently sustainable under current assumptions, would increase national savings (because at least part of the contributions to the private accounts would be a net addition to private savings), and would improve, rather than deplete, the unified budget. Let me commend that statement to your attention.

Health Care

Close observers of the federal budget will be quick to note that the long-term budget problem is to a much greater extent driven by health-care costs – Medicare and Medicaid – than by Social Security. In fact, some might go so far as to characterize Social Security restructuring as mere batting practice for the real contest against rising health-care costs. We do need our batting practice, and fixing Social Security could be an important confidence-builder before the main event. But we must move on to the inevitable big game with health care.

Let me offer two cautionary notes with respect to health-care costs. First, it is difficult to conceive of policies to cut the federal government's health-care costs without restructuring of the health-care system as a whole. One could not imagine physicians under Medicare and under the private market practicing side by side for very long at significantly different and diverging reimbursement rates or levels of productivity. Furthermore, our health-care system is no more sustainable for private employers, who pick up the bill for much of the working-age population and their dependents, than it is for the federal government, which is responsible for much of the bill for the elderly. Thus, to fix the health-care system for the elderly, we almost certainly must fix it for everyone.

Second, it is hard to imagine a simple "CBO-scorable" fix for Medicare or Medicaid – short of a reduction of program coverage that would be not much less dramatic than offering the very ill only an icy lake and a canoe with no paddle. The federal government's experts already have learned that reductions of reimbursement rates of the depth that would be necessary to balance the system in the long run would elicit almost equally sharp increases in the volume of services provided – through which providers would attempt to maintain their incomes. Moreover, such reimbursement reductions would not be sustainable in the context of our mixed public and private system; large numbers of physicians simply would refuse to serve Medicare patients.

Therefore, to solve our impending federal health-cost crisis, we will need a fundamental restructuring of the entire health-care system, along lines that will yield a qualitative, not just a measurable and quantitative, change in the way health care is delivered. CED looked at these issues in 2002, and we now conclude that we underestimated the magnitude of the structural change required. Accordingly, we are revisiting the issue. We are starting with the employment-based health-care system for working-aged persons and their dependents, in a way that we believe will have important synergies with federal programs for the elderly. Although our deliberations are not yet complete, we have tentatively settled on a system that would give to the working-aged population a menu of choices similar to those available today to federal workers under the Federal Employees Health Benefits Program (FEHBP), and to a few consortia of private employers around the country. An independent government agency (perhaps structured like the Federal Reserve Board of Governors) would play the regulatory role of the Office of Personnel Management (OPM) in the FEHBP – including, for example, setting minimum standards for the insurance policies that are included in the menu. Persons would receive defined contributions such that everyone could obtain the low-priced plan that meets the appropriate standards, but those who want more expensive coverage would be responsible for the incremental cost out of their own pockets. Issuance would be guaranteed, regardless of preexisting conditions; insurers' premium revenues would be risk-adjusted, so that insurers who for whatever reason attracted disproportionately good risks would compensate those who took on the burden of caring for the more-costly risks.

Beyond universal coverage, the goal of this approach would be to encourage consumers to be cost-conscious choosers of their health-insurance plans, rather than of individual medical services. We believe that it is feasible for consumers to make informed responsible choices of insurance plans during an annual open season, with the help of an impartial regulator – just as federal employees are generally satisfied with the choices given them by the OPM and the FEHBP. In contrast, we find it implausible that consumers would shop successfully for lower prices for individual medical treatments while subject to serious illnesses. Note in this context two important factors: First, the great bulk of health-care spending is undertaken by persons spending far more than any feasible deductible amount for a High Deductible Health Plan (sometimes also known as a Consumer Directed Health Plan). In other words, the people who are spending most of the money under CDHPs will have no incentive to economize on their spending. Second, medical decisions under serious illnesses can be far more complex than the issues involved in the choice of a health-care plan.

We believe that consumers making cost-conscious choices of health insurance plans will drive both insurers and health-care providers to improve efficiency, so that they will be able to offer better service at lower prices, and thereby attract more customers – just as every other industry in the U.S. economy has learned to seek greater efficiency so as to remain competitive. In fact, we believe that such efficiency, diffused through the health-care sector from the coverage of the working-aged population to the federal programs for the elderly, is the only way in which the nation as a whole can enjoy high-quality and affordable health care.

Revenues

The remaining major component of the budget is revenues. No one likes the prospect of higher taxes. However, we should consider three incontrovertible realities:

First, as the U.S. population ages, there will be needs for greater funds for the federal government's largest programs – Social Security, Medicare and Medicaid. Some have suggested that the aging of the population should be a budget-neutral change, because as the federal government provides for the more-numerous elderly, it can spend relatively less on children, who will be a correspondingly declining share of the population. The problem with this logic is that the elderly are more expensive than children. Children generally come with parents attached, to provide their basic support. Furthermore, children are generally healthy. Thus, government's cost of providing for children is usually comparatively modest. In contrast, support for the elderly often includes the equivalent of full subsistence through Social Security, because our society has not shown itself willing to put responsibility for our elderly directly on their own children. In addition, the elderly in general have developed far greater medical needs than children. As a result, as the population ages, the nation will need significantly more in revenues to provide the kind of government support and services that we now expect.

Just do the math: Assume for sake of argument that the nation solves the rapid growth of the per-person cost of medical care for the elderly – which we are far from accomplishing thus far. It is widely understood that the ratio of the elderly to the working-aged population over the next 30 to 40 years will rise from about one to three, to one to two. That fact alone would suggest an increase in the relative cost burden of the elderly of about one third (taking the elder from about 25 percent of the adult population to about 33 percent, an increase of about one third). For that very simple reason, the federal government is likely to need a somewhat larger revenue base than it has had in the post-World War II years to date.

Second, consider that any plan to cut the costs of the major entitlements for the elderly – Social Security, Medicare and Medicaid – will take some years to bear fruit. As noted earlier, the President very correctly maintained that reductions in Social Security benefits cannot fairly be imposed even on those several years away from retirement, because people deserve fair warning so that they can make workable plans. That postpones the realization of savings from any plan to strengthen Social Security's finances. Likewise, the health-care sector is a massive share of the U.S. economy, with substantial long-lived investments in equipment and buildings, and substantial lags in the training of new personnel with new and different skills. Any efforts to change this very large sector of the economy will take time. Accordingly, once the retirement of the baby boom and the aging of the population begin to have their effect, the nation is likely to run larger deficits and accumulate more debt for some time before even the best spending reduction policies begin to have their effect.

Third, as debt accumulates, it breeds debt service obligations. Debt and debt-service are the prime forces behind every financial disaster. Even granting that the major long-term budgetary problems facing the United States are Social Security, Medicare and Medicaid, it should be clear that the nation will need to use other tools to reduce its accumulation of debt in the near and intermediate term – to "buy time" until repairs for Social Security and Medicare can become effective.

The role of debt service in the gloomy long-term budget outlook should not be underestimated. In the middle-of-the-road path in its most recent long-term budget projections (December 2005), CBO projected that total budget outlays in 2030 would be 27.1 percent of GDP – of which 4.6 percentage points of GDP would be spent on interest. Consider also that even if a budget were sent into deficit solely by insufficient revenues, it would eventually look like a spending problem – because the insufficient revenues would cause budget deficits, which would accumulate into a larger debt, and cause interest expense to grow. The interest expense, of course, is counted in the budget as outlays, no matter what the cause of the corresponding debt.

And for those who most abhor the prospect of a tax increase, I can only suggest that they consider the tax increases that await their children and grandchildren if the nation procrastinates in facing up to the budget problem. Economists from all over the political spectrum acknowledge that future generations will be burdened by current deficits. We sometimes hear people say that they resent paying taxes because they do not believe that they receive anything in return. Apart from all of the often-forgotten services that we receive in whole or in part because of federal activity or subsidies – from national security to clean water – people do in fact receive "nothing" in return for their taxes to the extent that they pay those taxes to service the public debt. As the debt grows and our children pay higher and higher taxes to service the debt that we are accumulating because we do not have the maturity to pay our own way, they may become cynical about government – but more appropriately, they ought to be cynical about us.

Please note that already in fiscal year 2006, debt service was the fastest growing major spending category in the federal budget – increasing by 23.2 percent in just one year.

CED has considered the interest in fundamental tax reform in the context of the federal government's broader fiscal predicament. We have concluded that the federal income tax is no longer strong enough to carry its recent share of the burden. Accordingly, we have recommended that the federal government adopt a value-added tax, while restructuring the income tax and its low-income support provisions (such as the earned income tax credit) to maintain fairness and progressivity. The combined yields of the two taxes should be sufficient to put the federal budget back into surplus, thereby reducing rather than increasing the debt-service burden as the baby-boom generation moves into retirement. The nation should shed its apparent phobia for debt reduction, which contributed to the decision to dissipate the hard-earned budget surpluses of the 1990s. This would give us the time to find, enact and implement the most effective reforms for Social Security and – especially – health care, so that we keep our nation's finances sound and sustainable, and avoid much heavier tax burdens for the generations to follow us.

How To Get There

Finally, a brief note on process: With one exception, all of the major successful deficit-reduction efforts in this country have been achieved on a bipartisan basis, through comprehensive negotiations. I see no reason to doubt, and every reason to believe, that shared responsibility and compromise will again provide the greatest possibility of success. Controlling the deficit will require painful choices, and for a majority to act, both sides must accept a stake in the process. Those who care about the future of this country will look for a way to reach a workable compromise that both sides will accept and from which neither side will profit at the expense of the other. Of course, the American people, in their wisdom, always ultimately recognize and reward the true leaders.

I hope that CED's work on these issues will prove helpful to you in your deliberations, and I thank you for the opportunity to bring our findings to your attention.

Chairman CONRAD. Thank you.
Dr. FURMAN.

STATEMENT OF DR. JASON FURMAN, DIRECTOR, THE HAMILTON PROJECT AT THE BROOKINGS INSTITUTION

Mr. FURMAN. Mr. Chairman, Senator Gregg, other members of the committee, thank you for the invitation to testify in one of the most important issues facing our Nation, the long-run budget deficit.

Restoring fiscal balance is essential to the current and future health of our economy. You have done such an excellent job outlining the problems we face that I will move over it very quickly, except to underscore that in my judgment there are three main sources of the fiscal gap and in order they are No. 1, the health system, and that is the private and public health system taken as a whole. No. 2, the tax cuts enacted since 2001 which, if made permanent with associated AMT relief, would total 2 percent of GDP. And then No. 3 would be the long-run outlook for Social Security, which faces a shortfall, its trustees estimate, of 0.7 percent of GDP.

With that context, I want to briefly review three steps we can take to address the long-run deficit. My written submission contains more details on all of these topics.

Step one, restore the PAYGO rules and stick to them to stem the flow of red ink. Remarkably, two-thirds of the 75-year fiscal gap was enacted since 2001. Of what I estimate as a 6 percentage point deficit over the next 75 years (and people who look at 50 years and use different assumptions will get different numbers), 2 percentage points are due the tax cut if made permanent, 1 percentage point is due to the Medicare prescription drug benefit, and 1 percentage point is due to increased discretionary spending on defense and homeland security, not counting Iraq and Afghanistan.

If PAYGO had been in effect and enforced over the last 6 years, we would have had a surplus today and a considerably smaller long-run challenge.

Additionally, Congress can adopt budget rules that stop discretionary spending from growing faster than needed to fund current policies and that end the practice of using the reconciliation process afforded by the budget resolution to increase the deficit.

Step two, take some simple steps—comparatively simple steps, I should say—to reduce the deficit today. To restore fiscal balance more must be done than simply restoring PAYGO. Restoring fiscal balance will require some combination of spending below and revenues above the baseline that requires the support of both political parties.

In my testimony I discuss the MedPAC recommendations and the tax gap. Here I want to go into a little bit more detail on two other recommendations.

First, there should be no more new tax cuts. The Economic Growth and Tax Relief Reconciliation Act of 2001 phased in tax cuts over a 10-year period. Several of these tax cuts are not fully in effect, including the repeal of the personal exemption phaseout, the repeal of the Pease rule that phases out itemized deductions, and the repeal of the estate tax.

These cuts were enacted in an era of surpluses and before 9/11 brought our attention to homeland security challenges. Now that we are again in deficit and spending is elevated, further tax cuts above and beyond what is in the law today make no fiscal sense.

Second, let us correct the indexing of Social Security, the tax code, and other programs. Policymakers wisely index Social Security benefits and tax brackets to adjust for the cost of living. But the consumer price indices used for this purpose overstate inflation.

Specifically, they ignore the fact that consumers partially insulate themselves from shifting prices by switching from goods whose relative prices are rising to ones whose relative prices are falling.

Although policymakers should not substitute their judgment for that of the nonpartisan professionals at the Bureau of Labor Statistics, policymakers must use their judgment to pick the most reliable of the many price indices that are available today and compiled by the professional statisticians. A good candidate is the Chained CPI. Since its inception in 1999, this index has run 0.5 percentage point lower than the traditional CPI. If all Federal programs and taxes were switched to the Chained CPI, by the end of the decade the Government would save more than $40 billion with the bulk of the savings divided roughly equally between preventing de facto Social Security benefit increases and tax cuts that Congress never intended. Over time the savings would continue to grow.

Step three entails addressing Social Security, Medicare, Medicaid and tax reform. I want to briefly mention one idea in each of these areas. First, Social Security reform. Uncertainty about the future of Social Security should not be used as an excuse not to act, but it should be a motivation to provide for foreseeable contingencies. If the future is much better than we expect, benefit reductions and/or tax increases should automatically be smaller. If it is much worse than we expect, the opposite should happen automatically without having to wait for Congress to act. In addition to sustainable solvency, policymakers should strive to achieve robust solvency.

One promising way to introduce more robustness into the system is to use dependency indexing, which links changes in replacement rates or payroll tax rates to changes in the ratio of workers to retirees. In a pay-as-you-go system, the dependency ratio is the variable that determines the payroll tax rate needed for any given replacement rate. It is a function of current and past fertility rates, mortality rates, and immigration.

If, contrary to current predictions, Social Security does not face any financing problems, a measure like this can effectively shut off any benefit reductions or tax increases, removing one of the major objections to undertaking Social Security reform today.

Second, in the realm of health, reforming the $200 billion in annual tax subsidies for health insurance, if done right, can expand coverage, improve cost-effectiveness, and reduce the long-run deficit. But reform done wrong could undermine the employer-sponsored system without creating an alternative, increasing the total number of Americans without insurance. This is a very important issue because it is right at the intersection of the private sector and the public sector that is so much a part of the health system.

Converting the current tax exclusion from employer-sponsored insurance into a tax credit or a voucher would make the subsidy more progressive, provide a bigger incentive for people to get insurance, and reduce the long-run savings. But this would work only if it were done at the same time that major steps were taken to strengthen pooling arrangements and expand health insurance coverage through the public and private sectors.

Finally, when it comes to tax reform, I have sketched several options in my written submission, including proposing to curb tax expenditures for corporations and convert individual tax reductions to tax credits. In addition, we could rely more on taxes that correct distortions and improve the functioning of markets.

For example, as N. Gregory Mankiw has argued, “A tax on carbon is the best way to deal with global warming.” Combined with other tax cuts for working families, such a policy need not be regressive.

The fiscal problems this committee is trying to address are very difficult, both economically and politically.

Thank you for the opportunity to contribute to your efforts.

[The prepared statement of Mr. Furman follows:]

Options to Close the Long-run Fiscal Gap

Jason Furman
Senior Fellow, The Brookings Institution
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Testimony Before the U.S. Senate Committee on Budget
January 31, 2007

Mr. Chairman and other members of the Committee, thank you for the invitation to testify today on one of the most important issues facing our nation: the long-run budget deficit. I currently serve as Director of the Hamilton Project at the Brookings Institution, an initiative dedicated to developing policies to promote broad-based growth and opportunity. Restoring fiscal discipline plays an important role in achieving all of these objectives. Note that none of the specific options I am discussing today have necessarily been endorsed by staff, officers, or trustees of The Brookings Institution, or the members of The Hamilton Project Advisory Council.

The Congressional Budget Office (CBO) projects that the unified deficit in fiscal year 2007 will be $198 billion.[1] This amounts to 1.5 percent of Gross Domestic Project (GDP), which is less than the average over the last forty years. This may lull some into a false sense of complacency. It should not. The United States can do a lot better than a $198 billion unified deficit and the United States needs to do much better than a $388 billion non-Social Security deficit. This is especially true in a year when macroeconomic performance is strong and when we face large risks including the private savings rate at its lowest level since 1939, a current account deficit approaching 7 percent of GDP, and major fiscal challenges just around the corner.

Restoring fiscal balance will require three steps:

- Step one: To stem the flow of red ink, restore the PAYGO rules;
- Step two: Take simpler steps to reduce the deficit today;
- Step three: Address Social Security, Medicare, Medicaid and tax reform to bring the government's books into balance over the longer term.

The deficit represents a major economic challenge. It drives down national savings, leading to less investment or more foreign borrowing. In either case, future national income will be lower, either because we will have a smaller capital stock or because more of our capital stock

[1] This estimate includes $26 billion additional outlays for Iraq and associated debt service.

will be devoted to producing income to repay our foreign creditors. This effect is slow and gradual but relentless and inevitable. In addition, the budget deficit and the related large current account deficit increase the chances of a highly disruptive short-run financial crisis. If America finds itself suddenly unable to borrow 7 percent of GDP, the economy would need to rapidly reallocate a large fraction of the labor force from domestic production to export production. This adjustment process could be painful as millions of workers would need to find jobs in new industries in short order.

Even setting aside the economic effects, current tax and spending policies are literally unsustainable. The sooner we act the better for three reasons. First, the earlier we increase revenues or reduce spending, the smaller the eventual adjustments will have to be because we will not accumulate as much debt and thus will save a lot on interest payments. Second, if addressing our long-run fiscal challenge entails altering currently-scheduled benefits for future retirees, more notice about such adjustments will improve workers' ability to prepare. Finally, even if much of the actual revenue or spending changes themselves do not occur for decades, scheduling them sooner may be politically easier than waiting until the necessary changes are imminent.

I will first briefly review the sources of our long-run deficit and then discuss the three steps we should take to address it.

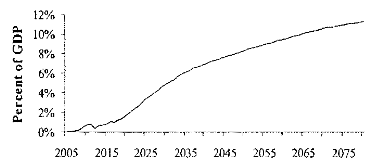
The Long-run Outlook

The long-run fiscal challenge is a fact, although precise estimates of its magnitude are sensitive to assumptions and projections about the future. The Center on Budget and Policy Priorities recently released an important analysis of the long-run deficit that I recommend to this committee.[2] My own estimates, in preliminary work with economists Alan Auerbach and William Gale, indicate that stabilizing the debt-to-GDP ratio over the next 75 years would require an immediate and permanent increase in taxes or reduction in spending of about 6 percent of GDP.[3]

Policymakers do not have to close the entire fiscal gap today. Changes could be phased in slowly over time, or enacted over time. If this is the course we choose to go down, it would be useful to understand what future changes would be required to stabilize the debt-to-GDP ratio on an annual basis. Figure 1 shows preliminary estimates of these changes as a share of GDP. Relatively small changes are needed today, but in the future growing policy changes will be needed, totaling about 1 percent of GDP in 2015, 2 percent of GDP in 2020, 5 percent of GDP in 2030, and 11 percent of GDP in 2080. Ultimately these changes are far larger than what would be required from an immediate adjustment.

[2] Center on Budget and Policy Priorities, "The Long-Term Fiscal Outlook is Bleak," October 11, 2006.
[3] The precise magnitude of the change is very sensitive both to projections about the future and technical assumptions about the evolution of policy in different areas.

Figure 1. Changes in Outlays Required to Stabilize the Debt-to-GDP Ratio



These long-run budgetary imbalances stem from a fundamental disconnect between what we expect from our government and what we currently pay for it. The long-run fiscal problems we face do not stem primarily from the government trying to do more for its citizens; instead, the government is simply trying to do the same, but for an aging population and in an era of increasing health spending.

The three main sources of the fiscal gap, in order of importance, are:

- **Rising health spending in both the private and public sectors.** The United States continues to be a leader in developing and using amazing technologies to improve our health, but these technologies are expensive. This innovation creates a financing challenge for both the private and public sectors. Spending in Medicare and Medicaid are comparable to that in the private sector both in level (adjusted for age and health) and growth rate. And, as in the private sector, this spending is rising rapidly. If Medicare and Medicaid stabilized at their current share of GDP – and the simultaneous erosion of income tax revenue due to the rising share of untaxed health insurance were halted – the fiscal gap would be reduced by more than 5 percent of GDP, nearly eliminating it. Although freezing healthcare as a share of GDP would be infeasible and undesirable, it is a useful conceptual exercise to appreciate the magnitude of the health challenge.

- **The tax cuts enacted since 2001.** The tax cuts enacted from 2001 to the present, together with associated relief from the Alternative Minimum Tax (AMT), would total 2 percent of GDP if made permanent. (Without the associated AMT relief the tax cuts would total 1.5 percent of GDP.)

- **The challenge of financing past generosity in Social Security in an environment with fewer workers for every retiree.** Social Security has a large "legacy debt" associated with the fact that the first generations of beneficiaries received substantially more than they paid into the system. This debt – which we inherited from past decisions by past policymakers – must be financed over time. This financing process becomes harder as a fertility rates fall and life expectancies increase. As a result, the Social Security system faces a shortfall equivalent to 0.7 percent of GDP over the next 75 years according to the Social Security Trustees.

There is a large range of uncertainty in long-run forecasts. But uncertainty is no excuse for inaction. If the future turns out better than we expect then policymakers will have the luxury of cutting taxes or raising benefits. If the future turns out worse than we expect then at least we will be in a position to address the problems. But uncertainty does have one important implication which I will discuss more below: it makes building robust contingency measures into our long-run budget essential.

Step One: Restore PAYGO Rules – and Stick to Them to Stem the Flow of Red Ink

Remarkably, two-thirds of the fiscal gap is the result of legislation enacted since 2001, either in violation of PAYGO rules or in the absence of these rules. Of the 6 percentage point 75-year fiscal gap, 2 percentage points are due to the tax cuts enacted since 2001 (if they are made permanent along with the associated AMT relief). Another 1 percentage point is due to the establishment of the Medicare prescription drug benefit, the first major entitlement expansion to be enacted without an associated revenue source. Finally, 1 percentage point is due to increased discretionary spending, entirely for defense and homeland security.[4]

The surest way to stem the flow of red ink is restoring the PAYGO rules for taxes and entitlement spending, attempting to restrain discretionary spending from growing faster than needed to fund current policies (which would likely be higher than inflation due to factors like population growth and health spending that affect some discretionary programs), and ending the practice of using the reconciliation protection afforded by the budget resolution to increase the deficit. But rules are not enough. Policymakers should stick to these rules, including applying them to any reform of the AMT.

But PAYGO rules should not be perceived as a policy straightjacket. These goals can be achieved together by designing intelligent policies and making smart and sometimes tough choices about the role we want government to play. For example, The Hamilton Project has released discussion papers on how to improve unemployment insurance by reforming the existing expenditures and will be releasing proposals on how to better utilize our existing funding for higher education. If new expenditures or tax benefits are needed, other unneeded areas of government should be cut or revenues should be raised to cover the costs. A basic test of any new program is that the electorate should think it is worth paying for.

PAYGO rules and discretionary restraint guided President Bill Clinton, Speaker Newt Gingrich and Majority Leader Bob Dole in the 1990s. If they had been maintained in the 2000s we would have a budget surplus today and a considerably smaller long-run fiscal challenge. Ideally both parties in Congress would come together with the President to restore PAYGO and the other budget rules. But in the absence of such an agreement, either branch of government, or even either party, has the ability to ensure that only legislation consistent with PAYGO is enacted. And PAYGO plus discretionary spending restraint would be sufficient to stabilize the debt-to-GDP ratio for the next decade or more.

[4] This is a conservative estimate of the impact of budget policy on outlays that does not count outlays for Iraq and Afghanistan and only counts increases in discretionary spending relative to GDP.

Step Two: Take Simpler Steps to Reduce the Deficit Today

PAYGO rules are only a first step and more will need to be done to get us out of the hole, including some combination of spending below and revenues above the budget baseline. Accomplishing this will require the support of both political parties. Policymakers can find a range of options in publications like CBO's *Budget Options* and places like The Brookings Institution's "Restoring Fiscal Sanity" initiative. In my testimony today I would like to flag four common-sense options for reducing spending or increasing revenues that are relatively simple to implement and could start reducing the deficit immediately.

- **Do not phase in any more tax cuts.** The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased in tax cuts over a ten year period. Several of those tax cuts are not fully in effect, including the repeal of the Personal Exemption Phaseout (PEP), the repeal of the Pease rule that phases out itemized deductions, and the repeal of the estate tax. These cuts were enacted in an era of budget surpluses and before 911 brought attention to our homeland security challenges. Now that spending is elevated and budget deficits have returned, further tax cuts do not make fiscal sense. Freezing them at their 2007 values would cause no harm to the economy and, in the case of PEP and Pease, 64 percent of the tax cuts being cancelled would have gone to households making more than $1 million.

- **Enact the MedPAC recommendations for Medicare.** MedPAC, a nonpartisan board that advises Congress on issues affecting the Medicare program, has proposed several revisions to Medicare overpayments. For example, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 increased payments to private Medicare Advantage programs. Although originally intended to save money, private plans in Medicare now cost considerably more per beneficiary than the traditional system. As MedPAC has observed, this "does not create incentives for the efficient provision of high-quality care."[5] In addition, MedPAC has proposed adjusting some payments to providers, both to improve medical outcomes and reduce spending.

- **Reduce the tax gap and close tax loopholes.** The Internal Revenue Service (IRS) estimates the net tax gap was $290 billion in 2001, which extrapolates out to about $5 trillion over the next decade. Better enforcement and simplifications that improve compliance, like requiring financial institutions to report the basis of capital gains, would help reduce the tax gap. The tax gap, however, is not a fiscal panacea, especially since much of the gap stems from cash transactions that are not disclosed to the IRS and cannot feasibly be monitored and enforced by the IRS. The tax gap is illegal evasion, but policymakers should also take steps to curb legal avoidance of corporate taxes. For example, Congress could close corporate loopholes, including codifying the economic substance doctrine and closing the Bermuda loophole.

- **Correct the indexing of Social Security, the tax code, and other programs.** Policymakers indexed Social Security benefits, the tax brackets, and other parameters of

[5] Medicare Payment Advisory Commission. *Report to Congress. Issues in a Modernized Medicare Program* (Washington, DC: MedPAC, June 2005)

tax and spending programs to adjust for the cost of living. The Consumer Price Indices currently used for indexation employ an outdated procedure that overstates inflation. Specifically, they ignore the fact that consumers partially insulate themselves from shifting prices by switching to goods whose relative price is falling. Although policymakers should not substitute their judgment for the nonpartisan professionals at the Bureau of Labor Statistics (BLS), policymakers should pick a more accurate measure of the cost of living. A good candidate is the Chained CPI-U (C-CPI-U) that BLS started releasing on a monthly basis in 1999. To date this index is running 0.5 percentage point lower than the traditional CPI. If all federal programs and taxes were switched to the C-CPI-U by the end of a decade the government would save more than $40 billion, with the bulk of the savings divided roughly equally between preventing *de facto* Social Security benefit increases and tax cuts that Congress never intended. Over time the savings would continue to grow.

All four of these steps are simple and, though not without controversy, could be implemented relatively easily. But more is needed to solve the long-run fiscal deficit.

Step Three: Address Social Security, Medicare, Medicaid and Tax Reform to Bring the Government's Books Into Balance Over the Longer Term

Solving our long-run fiscal problems is not just a matter of reducing spending and increasing revenue. We can also use the opportunity to improve Social Security, the health system, and the tax system. I will briefly sketch some ways to make our social insurance and tax systems more effective and more cost-effective.

Social Security

Social Security contributes less to the long-run deficit than the health system or the recent tax cuts. It would be wrong to use its long-run challenges as a pretext for undercutting the program by, for instance, diverting payroll taxes into private accounts, a step that would increase short- and long-term fiscal risks and would not contribute to solvency or benefit levels.

But this does not mean we should ignore the financing challenges facing our nation's most popular public program. Especially since the solvency options are well-understood and many Social Security experts are not very far apart in their reform efforts. The mere fact that Social Security outlays are projected to be larger than Medicare outlays for several decades suggest that Social Security's taxes and benefits should not be isolated from a broader fiscal solution.

Moreover, anyone who wants to maintain the highest feasible Social Security benefits should want to act sooner rather than later. The Social Security trust fund is projected to be exhausted in 2040, according to its Trustees. If we postpone reform until then, the future Social Security Commissioner would be legally required to limit benefit payments to payroll tax collections, a measure that would result in a roughly 25 percent reduction for *all* Social Security recipients. A 62 year old who starts collecting benefits this year would expect to get a 25 percent benefit cut on her 95th birthday.

Acting sooner would allow us to bring more revenues into the system to minimize the eventual benefit cuts. And, to the degree there were reductions in benefits, phasing them in over time would reduce their eventual magnitude and give workers more time to plan accordingly.

According to traditional neoclassical economics, there is no economic reason to prefer broad-based benefit cuts (including an increase in the full-benefit retirement age) to tax increases. Both would increase economic distortions (although the magnitude of the distortions is uncertain but unlikely to be very large). Cutting benefits, for example, means that workers will get less for their taxes, effectively increasing the portion of the Social Security payroll tax that is a true tax rather than a form of forced savings and insurance. Put another way, a worker could adjust his or her savings to achieve the identical stream of pre-retirement and post-retirement consumption under a tax increase or a benefit cut of similar magnitude. As the American Enterprise Institute's Kevin Hassett explained to this Committee last year, "a benefit reduction is as much of a tax hike to a rational individual as an explicit tax hike."[6] And for less than fully rational individuals, which is probably a good description of most of us, there is a strong rationale for Social Security to provide robust benefits that help ensure a reasonable level of retirement security.

You can find large menus of options for Social Security reform maintained by both the Social Security Administration's Office of the Chief Actuary and by the CBO.[7] I want to emphasize one important consideration. In addition to achieving sustainable solvency, policymakers should attempt to achieve *robust* solvency. Uncertainty about the future of Social Security should not be used as an excuse not to act. But it should be a motivation to provide for foreseeable contingencies. If the future is much better than we expect, benefit reductions and/or tax increases should automatically be smaller. If it is much worse than we expect, the opposite should happen automatically without having to wait for Congress to act.

The current system is designed to be largely immune from changes in productivity growth, since both taxes and benefits are effectively linked to productivity. Linking benefit reductions to the difference between wage growth and price growth, as is done in price indexing and progressive price indexing, would add to the instability of the system, delivering larger benefit reductions when economic growth was stronger and smaller benefit cuts when growth was weaker. Indexing benefit levels for longevity, the retirement age, or the payroll tax rate goes in the right direction – delivering larger adjustments as people live longer – but only captures a small part of the uncertainty about the future.

One way to introduce more robustness into the Social Security program would be to use *dependency indexing* which links changes in replacement rates or payroll tax rates to changes in

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[6] Kevin Hassett, Testimony Submitted to the United States Senate Committee on the Budget, September 28, 2006, http://www.senate.gov/~budget/republican/hearingarchive/testimonies/2006/2006-09-28hassett.pdf.
[7] See http://www.ssa.gov/OACT/solvency/index.html and http://cbo.gov/publications/collections/socialsecurity.cfm#pt3.

the ratio of workers-to-retirees.[8] In a pay-as-you-go system, the dependency ratio is the variable that determines the payroll tax rate needed for any given replacement rate.[9] It is a function of current and past fertility rates, mortality rates, and immigration. And it changes gradually over time, ensuring that any program changes are also gradual and largely moving in the same direction. If, contrary to current predictions, Social Security does not face any financing problems, a measure like this would effectively shut off any benefit reductions or tax increases.

Health Reform

We face three major challenges in the area of healthcare: covering the 47 million people that do not have insurance, ensuring that we are efficiently spending the right amount of money on health (which is likely to be less than what we are spending today), and paying for the care we choose to consume.

Unlike Social Security reform, there is no place to find simple and readily quantifiable menus of options for health reform. The choices facing individuals, companies, and the government are not nearly as simple or well understood.

The federal government plays an important role in these issues for three reasons. First, it directly pays for one-third of all healthcare, or an estimated $740 billion in 2006.[10] Second, public programs, especially Medicare, have so much market power that they set a major example – for good or for ill – for the entire private healthcare system. And third, the Federal government provides a $200 billion tax subsidy for employer-sponsored insurance that has profound effects on the form and nature of coverage in the private sector.

Ideally, we should move forward in all three challenges simultaneously. This is a process that will involve the private sector and the public sector and working along many different dimensions. I want to highlight one important dimension that is at the intersection of both the private and public sector: the tax treatment of employer contributions to health insurance. Reform, done right, has the potential to advance all three of the goals simultaneously: expanding coverage, reducing spending while improving its cost effectiveness, and reducing the long-run deficit. But reform done wrong would risk undermining the employer-sponsored system without creating a robust alternative in its place, shattering risk pooling and either increasing the total number of Americans without insurance or pushing sicker people into the ranks of the uninsured.

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[8] A number of countries, including Germany, Japan, and Sweden, have introduced forms of dependency indexing in recent years. U.S. Government Accountability Office, "Social Security Reform. Implications of Different Indexing Choices," September 2006, http://www.gao.gov/new.items/d06804.pdf.

[9] In general, when a pay-as-you-go system is in balance the following holds:

Payroll Tax Rate = Dependency Ratio x Replacement Ratio

So, for example, if the payroll tax rate is 10 percent and the dependency ratio is one retiree for every three workers, then the replacement rate can be 30 percent. If the dependency ratio falls to two workers per retiree, then payroll taxes need to rise to 15 percent, the replacement rate needs to fall to 20 percent, or perhaps some combination like a tax rate of 12.5 percent and a replacement rate of 25 percent

[10] Center for Medicare and Medicaid Services, NHE Projections 2005-2015, Forecast Summary and Selected Tables, http://www.cms.hhs.gov/NationalHealthExpendData/downloads/proj2005.pdf

Converting the current tax exclusion for employer-sponsored insurance into a tax credit or a voucher would make the subsidy more progressive, provide a bigger incentive for people to get insurance, remove the incentive to have more generous insurance and make the financing of healthcare more transparent. In the process, the policy could also be designed to reduce the long-run deficit. But all of this would work *only* if it were done at the same time as major steps were taken to strengthen pooling arrangements and expand health insurance coverage, through some combination of retaining some tax advantage for employer sponsored insurance or enacting new subsidies for small businesses, an expansion of public programs, and the creation of new buy-in arrangements for people without access to affordable care.

Tax Reform

Unless policymakers want to reduce outlays in Social Security, Medicare, Medicaid, and other spending by 6 percent of GDP over the next 75 years, higher revenues will be needed to close some of the fiscal gap. At a bare minimum, the top two rates should be restored to what they were at the beginning of the decade. This would cause minimal, if any, economic harm. In fact, the associated deficit reduction could well contribute to a stronger economy for all Americans, just as it did in the 1990s.

But we can do even better by using the fiscal challenges and the expiration of the tax cuts in 2010 as an impetus to undertake a broader reform of the tax system. If revenues have to increase over time, it will become more important than ever to raise them in the most economically efficient manner. This is one lesson of Peter Lindert's important book *Growing Public* which pointed out that many European countries have substantially higher taxes than the United States but collect those taxes in a much less economically distortionary manner.[11]

One promising strategy for tax reform would be to go beyond the tax gap and corporate loopholes to a more substantial broadening of the corporate income tax base. In the last budget the Treasury listed a total of $104 billion in tax expenditures for corporations, nearly one-third as much as the corporate tax revenue that was actually collected.[12] The President's Advisory Panel on Federal Tax Reform included a comprehensive proposal to eliminate many of these tax expenditures, arguing this would improve economic efficiency while raising more revenues.[13] These proposals, and others, merit serious consideration.

A second promising strategy would be to turn individual income tax expenditures into credits, possibly as part of a broader base broadening process. Tax credits are more progressive and put more money into encouraging the activity they were designed to encourage (e.g., purchasing health insurance, owning a home, going to college, or saving for retirement) and less

[11] Peter Lindert, *Growing Public: Social Spending and Economic Growth Since the Eighteenth Century*, (Cambridge, UK: University of Cambridge Press, 2004).
[12] Note that this total is indicative of the extent of tax expenditures but is not an estimate of the revenue that would be raised by repealing these tax expenditures because it ignores behavioral effects and the interaction of tax expenditures with other provisions in the tax code and other tax expenditures.
[13] Note there are substantial corporate tax expenditures even relative to a consumption tax base. Many of the existing tax expenditures also apply to a consumption tax base and, in addition, measuring tax expenditures against a consumption tax base would show the deductibility of interest as a tax expenditure.

money into subsidies for upgrades (e.g., purchasing *more generous* health insurance, owning a *larger* home, or going to a more *expensive* college) or into economically inefficient windfall subsidies to people who would have undertaken the same activities in any event.

A third promising strategy for tax reform is to rely more on taxes that correct distortions and improve the functioning of markets. For example, as N. Gregory Mankiw has argued, "A tax on carbon is the best way to deal with global warming."[14] Such a tax change could be done in the context of a revenue neutral, distributionally-neutral tax reform or as a revenue-raising solution to the long-run fiscal gap. Alternatively, the same price mechanism could be implemented though a cap-and-trade system for carbon, with appropriate rules for auctioning off permits.

Concluding Reflections

The fiscal problems this Committee is trying to address are very difficult, both economically and politically. Thank you for the opportunity to contribute to these important efforts. I look forward to answering your questions.

[14] N. Gregory Mankiw, "Mr. Paulson's Challenge," *Wall Street Journal*, May 31, 2006.

Chairman CONRAD. Dr. Butler, welcome.

STATEMENT OF DR. STUART M. BUTLER, VICE PRESIDENT, DOMESTIC AND ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION

Mr. BUTLER. Thank you, Mr. Chairman and members of the committee.

I think you will hear there are some elements of agreement on this panel on a number of steps, although disagreements on some others.

As Comptroller General David Walker observed, the present value of the unfunded obligations of the Federal Government is the equivalent of placing $170,000 mortgage, without a house as a corresponding asset, in the crib of every baby born in America. You have asked the panel what we should do about this.

It may be tempting to say that we should raise taxes to keep pace with the mounting entitlement obligations, but there are at least two reasons why this would not be the right course, in my opinion. First, a lack of future revenue is not the problem. Spending is. Federal taxes are already projected by CBO to rise to their highest level ever as a percent of GDP over the next 15 years and then they will keep rising. Raising taxes faster than that risks slowing economic growth.

Second, we are currently scheduled to pay for the huge cost of baby boomer retirement benefit by borrowing money from our children and grandchildren. But the way to stop borrowing money from our children and grandchildren is hardly to take their money in the form of new taxes. What we need to do instead is admit that we have overextended ourselves and seek fair and reasonable ways of reducing future entitlement spending by focusing resources only on those who really need help.

To do that, Congress should take the following steps: first, Congress should replace the drug benefit provision in the Medicare Modernization Act with a targeted benefit instead. The Part D benefit is a huge and unaffordable new entitlement. Instead of subsidizing drug purchases for all retirees, Congress should repeal the general subsidized benefit and replace it with a limited benefit targeted to only needy seniors.

Second, if you will not revamp the drug benefit, at least introduce full income testing for Medicare Part D and also for Medicare Part B. These parts of Medicare are not social insurance programs. They are heavily subsidized voluntary insurance programs. Congress should fully income adjust these parts of Medicare, raising premiums to 100 percent of their real cost value for affluent seniors.

Third, it is time to fully income test Social Security benefits for higher income seniors. Congress has already accepted the principle of including Social Security benefits in taxable income in order to recoup some of the benefit costs. The appropriate next step is to phase in 100 percent income-related benefits for all single seniors with incomes above 25,000 and married couples above $32,000. The full 100 percent inclusion in taxable income should apply on single incomes over $35,000 and married couples over $45,000.

Fourth, encourage Americans to work longer. We cannot sustain a retirement system in which typical Americans can plan on spending one-third of their adult life in retirement with financial support guaranteed from other working Americans. Congress needs to encourage Americans to increase their time in the work force by eliminating disincentives that discourage people from working longer.

As an incentive to work longer, Social Security taxes should not be imposed on people who work after their normal retirement age. Since half the payroll taxes are paid by employers, the employers themselves would also have an economic reason to retain older workers longer.

We need also to gradually increase the Social Security retirement age to at least 70 and to speed up the current scheduled increase to 67. After that, the retirement age should be automatically adjusted to reflect projected increases in longevity. And I think the dependency aspect that Dr. Furman mentioned is also an important way of changing it.

Fifth, we need to focus the growth of Social Security benefits on those who need them most and trim the rate of increase for those retirees who need them least. This can be done through progressive indexation where the benefits of upper income workers would increase only at the rate of inflation while benefits accruing to lower income workers would continue to grow under today's wage growth formula.

And sixth, Congress should change the status of retirement entitlements in the budget process. The current process has two major shortcomings. The first is that the long-term cost of existing entitlements is ignored in the annual budget cycle, so Congress is not forced to tackle the huge unfunded obligations.

The second is that entitlements have the first claim on spending, whether or not benefits for some individuals really should have top priority. Today, retired millionaires automatically preempt the homeless and our soldiers in Iraq in the struggle for Federal funds.

To fix this, Congress needs to take two steps. One is to include a measure of long-term budgetary situation prominently in the annual budget with a requirement that Congress go on record each year with a vote to increase or reduce long-term obligations.

Building on this first step, I believe Congress should also begin to eliminate the preferred status of entitlement programs so that all programs are on the same level playing field and have real and limited budgets. The way to do this while still preserving a reasonable level of certainty for retirement planning would be to convert all retirement spending entitlements into 30 year budgeted programs that must be reviewed and reauthorized by Congress every 5 years.

I should note here that I come originally from Britain. Although the National Health Service is an open-ended entitlement in one sense, it is on a fixed budget and competes year-to-year with other budget priorities for the British government. I think that is the way to address health in this country, too.

Congress might utilize the Entitlements Commission proposed by Senator Voinovich and Congressman Wolf to propose an initial long-term entitlement budget. Thereafter, Congress might also use recommendations fro the National Entitlement Adjustment Condition, proposed by Senator Feinstein, to recommend ways of dealing with spending that begins to exceed the agreed 30-year budgets.

Mr. Chairman, this afternoon Mr. Bixby and I, together with David Walker and Isabel Sawhill from the Brookings Institution, fly to Iowa for a town hall meeting on options for dealing with the long-term fiscal problem. This will be our 19th such event. We found at each of these events that Americans are quite willing to talk about tough, bipartisan choices to reduce the burden on future generations.

Thank you for inviting me to testify, and I hope Congress too will also be prepared to consider tough choices in a bipartisan way.

[The prepared statement of Mr. Butler follows:]

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CONGRESSIONAL TESTIMONY

Solutions to Our Long-Term Fiscal Challenges

Testimony before
The Committee on the Budget
United States Senate

January 31st, 2007

Stuart M. Butler, PhD
Vice President
Domestic and Economic Policy Studies
The Heritage Foundation

My name Stuart Butler. I am Vice President for Domestic and Economic Policy Studies at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The new Congressional Budget Office (CBO) baseline once again underscores the scale of the entitlement spending problem:

- Medicare spending (including offsetting receipts) expanded 12 percent in 2006 and will grow 13 percent more in 2007. Combined Medicare and Medicaid spending now exceeds Social Security spending.
- The Medicare drug entitlement is now projected to cost $822 billion through 2017. It will cost $60 billion per year by 2012 and $119 billion per year by 2017. Its annual expense will continue to increase thereafter.
- Over the next decade, Medicare and Medicaid costs will surge by nearly 8 percent per year, and Social Security costs by 6 percent annually. These programs will rise from 8.5 percent to 10.7 percent of GDP as the baby boomers begin to retire.
- Meanwhile, notes the CBO, the federal government is not suffering from a dearth of revenues. Revenues are projected to grow from today's above-average level of 18.6 percent to almost 20 percent in 2012 and then continue at record levels as a percent of GDP.

But these 10-year figures actually only hint at the far more serious budget problem – the tsunami wave of entitlement spending that will hit the budget when the Baby Boom generation begins to retire in large numbers. As the CBO's long-term forecast indicates:

- The combination of the "big three" entitlements – Medicare and Social Security and Medicaid – will double from the current 8 percent of GDP to 15 percent when today's newborn graduates college, to nearly 20 percent pf GDP when today's college graduate reached retirement in 2050.
- With conservative assumptions, CBO projects that under current law the federal deficit will increase from today's 3.3 percent of GDP to about 20 percent in 2050.

As Comptroller General David Walker has pointed out, this entitlement-driven unfunded growth in spending will impose staggering financial burdens on our children and grandchildren:

- The total present value of unfunded federal obligations of the federal government, or fiscal exposure, is now $50.5 trillion ($38.8 trillion of which is due to Medicare and Social Security).

- This exposure translates into a financial burden of $440,000 for every household or, put differently, a mortgage of $170,000 placed in the crib of each and every baby born in America.

WHY RAISING TAXES IS NOT THE ANSWER

Given the scale of future entitlement spending, and the enormous unfunded obligations, it may be tempting to say that the prudent step would be to raise taxes to keep pace with the mounting obligations. But there are at least three reasons why this would be folly:

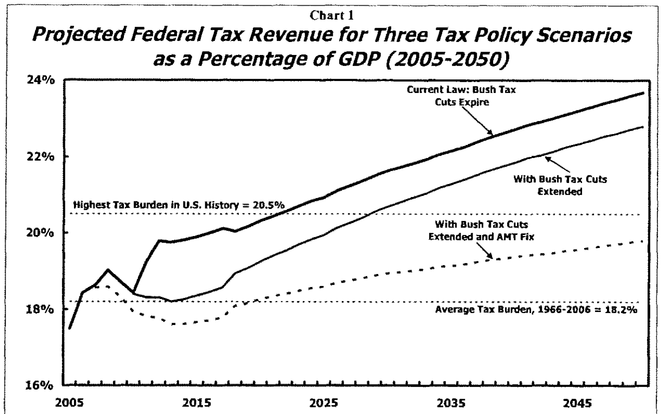
- **Falling tax levels are not the cause of the long-term problem.** Federal tax revenues currently are 18.6 percent, just above the historical level of 18.2 percent – a reasonable level of taxation that has helped the US economy perform consistently better than other major countries. Moreover, as Chart 1 indicates CBO's long-run forecast projects that federal taxes under current law will exceed their highest-ever level (20.5 percent in 1944 and 2000) by 2022 and rise to almost 24 per cent by 2050. That unprecedented level means the level of taxes as a percent of GDP would be one-third higher than the burden today. Even if the Bush tax changes were made permanent that would shave only about one percentage point off this rising tax burden.

  America does not face a long-term decline in the level of federal revenues as a percent of GDP. In fact, we face a worrying increase in the burden of taxation.

- **Raising taxes further would be damaging.** Any increase in taxes would be on top of this already record rise in the projected tax burden. If we were to balance the budget without tackling entitlements, and maintained discretionary spending at the same proportion of GDP as today, federal taxes would have to rise to almost 30 percent of GDP by 2050 – two-thirds higher than today. Add in state and local taxes of approximately 10 percent, and out children and grandchildren will face total taxes similar to low-growth, high-unemployment Europe.

- **Raising taxes on future generations would be immoral.** Raising taxes to address the long-term spending situation means increasing tax burdens on future generations to fund the huge future benefits this generation has voted itself. We in this generation have voted to pay for these benefits by handing steadily increasing credit-card bills to future generations. That is wrong, and should be corrected. But the way to reduce borrowing money from our children and grandchildren is not to take their money in new taxes instead. Every dollar of new taxes imposed on younger Americans to "fix" the long-term spending and deficit problem simply takes the place of a dollar we would otherwise borrow from the same people. If borrowing money from our children and grandchildren to pay for our excessive spending is immoral, then taking their money is even more immoral.

Chart 1



Source: CBO Long-Term Budget Outlook, December 2005 and Budget and Economic Outlook, January 2007.

HOW SHOULD WE ADDRESS THIS LONG TERM PROBLEM?

When a family has bought a house that is too big, and it cannot pay the mortgage, the answer is not to send its youngest members out to get jobs and for the parents to take second jobs. It is for the family to admit that is overextended and to move to a more modest house with a lower mortgage. That is what we must do with entitlements – admit that we have overextended ourselves and overcommitted our children and seek fair and reasonable ways of reducing future spending. That means looking hard at the promises we made to ourselves, and making reasonable and prudent changes – changes that still provide necessary resources to those who need them but reduce the burden on future generations.

To do that fairly and efficiently, Congress should take the following steps:

Replace the drug benefit provision of the Medicare Modernization Act with a targeted benefit

The 2003 Medicare drug bill was a huge and unaffordable new entitlement. Instead of providing help only to those seniors who needed help to afford their prescriptions, it provided a heavily subsidized drug benefit to all retirees on Medicare, including millions of retirees quite able to pay for their prescriptions. The new Part D program has increased unfunded obligations on future generations by a present value of $7.9 trillion – larger than the entire publicly held debt in 2000.

It is hard to imagine how the burden of future generations can be addressed without revisiting this unaffordable credit-card legislation. Congress should repeal the general subsidized benefit it enacted and replace it with a limited benefit targeted to only needy seniors.

Introduce full income testing of Medicare parts B and D

Parts B and D are not social insurance programs. Unlike Social Security and Medicare Part A these are not benefits that retirees "paid for" in payroll taxes during their working life. They are heavily subsidized voluntary insurance programs.

Today the Part B premium charged to seniors, even to millionaires, is just 25 percent of the true cost. For the Part D drug benefit, the premium charged for basic coverage is also approximately 25 percent of the total cost. Given the excessive spending level and future borrowing required to subsidize these voluntary programs, it is time to say that the subsidy should based on need. Richer seniors should have less, or no, subsidy for their Part B and D premiums.

The best step, as already noted, would be to repeal the new Part D drug program and replace it with a far smaller subsidy restricted to those who need. If that cannot be achieved, then the Part D and Part B premiums should be fully income adjusted, with Congress raising these premiums to 100 percent of their real cost for affluent seniors. At the very least, as an interim measure, Congress should make the subsidy in Parts B and D taxable for those with moderate and higher incomes, thereby recouping some of the subsidy for upper-income retirees.

Make all Social Security fully taxable for higher-income seniors

Recognizing the unfunded obligations of retiree benefits, Congress has already accepted the principle of taxing Social Security benefits in order to recoup some of the benefit costs. The tax applies to single seniors with annual incomes greater than $25,000 ($32,000 for couples). Above these incomes, seniors must pay tax on a rising proportion of their benefits (starting with 50% of benefits included in taxable income, rising to 85 percent).

With the principle of recouping unaffordable benefits in this way, it is time for Congress to phase in 100 per cent taxation of benefits all single seniors with incomes above $25,000 and married couples above $32,000. The full 100 per cent taxation should apply on single incomes of $35,000 and married couples with $45,000.

Eliminate Disincentives that Discourage Workers from Working Longer

As Urban Institute economist Eugene Steuerle pointed out almost a decade ago, today's workers are likely to have a longer lifespan, are healthier, and are less likely to work at physically demanding jobs that was the case for workers fifty years ago. A male American today who reaches 65 can expect to live about another 17 years, while a female can expect to live almost 20 more years. Yet, since the 1980s over half of workers retire at 62, with less than 20 percent saying that they retired because of ill health. We are approaching the point where typical Americans can plan on spending one-third of their adult life in retirement, with financial support guaranteed from other working Americans. This is not sustainable. Retirement programs should not begin at age 62. Workers can and should be encouraged to work longer.

Part of increasing working life will require cultural changes. Workers need to expect to work until later in life, and employers to value older workers for the experience they bring. But in addition, existing disincentives in the tax system need to be eliminated to make it more attractive to spend a more reasonable and sustainable proportion of adulthood at the workplace. A major disincentive today is that Social Security benefits are calculated on a worker's highest 35 years of earnings. So for an individual who works beyond today's normal retirement, the only way that working longer can increase benefits is if the worker's pay, indexed for wage growth, is higher at, say, age 68 than it was in his or her 30s. As an incentive to work longer, therefore, Social Security taxes should not be imposed on those who are employed after their normal retirement age. Since half of payroll taxes are paid by employers, they would also have an economic reason to retain older workers longer.

Gradually Increase the Social Security Retirement Age to 70

In the last major reform of Social Security, Congress recognized that increasing longevity required a gradual increase in the normal retirement age (NRA) – the age at which a worker can receive his or her full Social Security benefits – from 65 until 67. In the nearly quarter century since then, the average lifespan has continued to go up, and so it is time for Congress to again raise the normal retirement age to adjust for that increase in longevity. Today the NRA is 66, with a scheduled increase to 67 set to begin in 2020. This is too long to wait for an overdue adjustment. Congress should at least begin phasing towards 67 in 2010 at the rate of 2 months per year until NRA reaches 70 in about 2034. At the same time, Congress should gradually raise the early retirement age – the age at which a worker can receive a reduced Social Security benefit – from today's 62 to at least 65.

Future increases in longevity should lead to additional increases in these thresholds. Moreover, periodic changes to these thresholds for Social Security, and the eligibility age for Medicare, should be a regular part of the five-year re-examination of entitlement programs mentioned later in my testimony.

Focus Social Security Benefits on those who need them the most

The way to give additional meaning to Social Security's promise to insure workers against retirement poverty is to focus the system's resources on those who face the greatest hardship. The best way to accomplish this would be change the Social Security benefit formula so that the benefits of lower income workers grow at a faster rate than those for upper income workers. Under this "progressive indexation" proposal the benefits of upper-income workers (those who earn over $100,000 today) would increase only at the rate of inflation, instead of at the rate of wage growth as they do today. Benefits for lower-income workers (those who earn less than $25,000 today) who retire in the future would continue to grow as they would under today's benefit formula. This is only fair, because lower-income workers are less likely than other workers to have any other retirement savings and more likely depend on Social Security benefits for almost all of their retirement income. Meanwhile, middle- and upper-income workers, who are typically able to put aside money for retirement, would receive smaller increases in traditional benefits.

Progressive indexation preserves the principle of social insurance for workers of every income level, but it also recognizes that in an era of limited resources, benefits should be concentrated on those who need them the most. Depending on how this change is implemented, it could reduce Social Security's unfunded liability by about 60 percent. However, for it to be successful without reducing retirement income, Congress must also act to ensure that every worker has a retirement saving program that they are strongly encouraged to participate in from when they first go to work until the day they retire.

Change the budget status of retirement entitlements

The current budget treatment of entitlements has two major shortcomings, which frustrate attempts to put reasonable constraints on spending and thwart efforts to balance national priorities.

The first shortcoming is that the federal budget works on a pay-as-you-go system with a limited "look forward" period, with Congress using arbitrary five-year and 10-year budget windows. So the long-term cost of existing entitlements is ignored in the annual budget cycle, and the potentially huge cost of proposed new legislation is also ignored – which is why the multi-trillion unfunded long term cost of the Medicare drug legislation did not even have to be debated. Steps must be taken to require Congress to address long-term entitlement costs and unfunded obligations during the annual budget cycle by including a measure of these obligations in the budget process.

In addition, entitlements have first claim on spending whether or not benefits for specific groups of individuals really should have top priority. For example, this means that Part B subsidies for retired millionaires pre-empt help for the homeless, or most education spending, in the struggle for federal funds. A key element of the solution to the entitlement spending problem is to enable Congress to make more rational tradeoffs between the alternate uses of constrained future federal spending.

A two-step reform is needed to correct achieve these goals.

Step 1: Include long-term entitlement obligations in the annual federal budget

A critical first step would be to amend the budget process to include a present-value measure of long-term entitlement obligations and special tax preferences in the annual budget process and to specify changes in the present value in the annual budget resolution.

The annual federal budget thus should prominently include a measure of the long-term budgetary situation implications. In addition, the long term budgetary implications of proposals to expand or reduce entitlement programs should be included in the budget, with a requirement that Congress go on record each year with a vote, agreeing to an increase or decline in that long-term measure.

Last October the Federal Accounting Standards Advisory Board issued a report on calling for changes in financial reporting for social insurance programs that might form the basis of such a budget process change. As the FASAB emphasized, the nation must have better financial information that will force Congress and the President to address the mounting unfunded long-term costs of entitlement programs.

Step 2: Convert retirement entitlements into 30-year budgeted discretionary programs

Building on the first step, Congress also should begin to change the preferred status of entitlement programs, especially retiree programs, so that spending on some Americans is mandatory while spending on other, more needy individuals, is discretionary.

To be sure, while one group of Americans should not automatically have first call on spending, it is true that even a more affluent American planning for retirement requires a high degree of certainty about such programs as Social Security or Medicare. But this does not mean that we should continue to wall off these programs from a fair and balanced consideration of the needs of future retirees compared with other needs – including the financial security of younger Americans.

A way to achieve balanced consideration and priority for the needy with a reasonable level of future certainty would be to convert all retirement spending entitlements into 30-year budgeted programs that must be reviewed and re-authorized by Congress every five years. This long-term spending and financing plan could be explicitly and openly adjusted regularly every five years in light of such things as changes in technology, demographics, and national priorities.

To keep the programs within the approved long-term budget, Congress would apply "triggers" for each program. Such triggers would require default and automatic adjustments to features of the program if the trend of current and future spending is projected to move above or below the budgeted amount. The eligibility age for Medicare benefits, for example or payments to providers, for instance, could be adjusted. Congress would always be able to maintain the agreed budget glide path in another way. Indeed, Congress might utilize the National Entitlement Adjustment Commission, proposed by Senator Feinstein, to recommend ways in which Congress might deal with departures from the 30-year budget.

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Chairman CONRAD. Thank you, Dr. Butler.

Let me go to each of you and ask first, to me the notion of just doing it on the spending side of the equation is not going to work. Just doing it on the revenue side of the equation, not going to work. It is going to take some combination of additional revenue and spending restraint.

You know, I come to these meetings and I sometimes wonder if there is any possibility of getting these two sides together, because on one side they say no benefit reductions, period. And the other side they say no additional revenue, period. Pretty soon you have no solution, period. And I think that is about where we are right now.

And everybody is dug in. It is our way or no way. No compromise. No revenue, no cuts. That is what got us here and that is what is going to continue, that attitude is going to continue to prevent action, in my judgment. Because then neither side compromises.

Anybody that thinks one side is going to give in on their position and not the other side, to me is just detached from reality. This is going to take both sides giving up on their fixed position.

With that said, I would also say it is very clear to me the spending side of the equation is going to have to take most of the—is going to have to shoulder most of the effort here, because the baby boom generation is a reality. It is not a projection.

So let me first turn to the revenue side. Is there a way to get more revenue without increasing tax rates? Mr. Bixby, do you know of a way of getting more revenue without increasing tax rates?

Mr. BIXBY. The first thing you could turn to is what you had a hearing on earlier, which is the tax gap. We know that the current tax system does not collect all of the taxes that are owed. So step one would be trying to collect all of the taxes that are owed.

Now I do not know how much that would get you because there is obviously going to be some sort of a tax gap. I do not think we can assume that the tax system is going to collect every dollar that is owed. But the tax gap may even be wider than official estimates.

So I think an aggressive effort in that area is warranted.

Chairman CONRAD. Can I just interrupt you on that and say the head of the Revenue Service has told us he believes they could collect $50 billion to $100 billion a year without changing in a fundamental way the relationship of taxpayers and the taxing authority.

Mr. BIXBY. It would probably take some more investment in IRS to give them the tools and then you would run up against a thing of how aggressive do you want them to be, and what sort of push back you get it that point from taxpayers.

The second thing you can look at is the so-called tax expenditures or tax entitlements, things that are excluded now or things that you have deductions and exemptions for.

The President has put on the table ending the exclusion for employer-provided health care. He would devote the savings to new deductions but I mean there is—you could certainly bring in some new revenue that way.

You can look at things like the mortgage interest deduction, politically very sensitive but the President's Tax Commission did recommend that, as an alternative to the AMT. You have to look at ways to fund the AMT relief if you want to continue to do that.

So you could look at some of these big tax expenditures and think about closing some of those. But I am not sure that that is politically any easier than spending cuts because the people that benefit from them are quite passionate about them.

So there are ways you can look at—frankly, I know you have the big tax cut sunset coming up in 2010. You mentioned not raising rates but they all do expire. So it will take legislative action to extend them. And it does give you an opportunity. It is sort of the ultimate trigger to look at whether some of them are achieving their intended purpose or not, or whether we can afford them. And since they all do expire, you can get into a question about whether or not that is raising rates or not.

That is something that is on the table, certainly.

Chairman CONRAD. Dr. Minarik?

Mr. MINARIK. You had a hearing on the tax gap. Amen to everything Bob said. I was not able to look at the exchange that took place during that hearing in detail, in the remote possibility that some of these issues were not mentioned.

The resource issue for the Internal Revenue Service would be extremely important. In the past, when there have been efforts to try to improve their collection activities, they have generally been taken forward by taking their best people out of production, as it were, and putting them into training. So for a period of time, while the effort is underway, the activities are actually down. That suggests that you might need more resources fairly quickly to be able to increase the number of personnel and possibly keep some of the stronger employees working in the production part of the process.

A second consideration is informally one can hear that many of the major accounting firms consider the Internal Revenue Service to be a training program for them. What happens is the Internal Revenue Service goes out, hires personnel, gears them up. They go to audits, they are observed, the audit that the service is undertaking is in effect a job interview for the employees. And the best people get picked off fairly quickly.

What that suggests, I am an economist, if you want to hold onto people maybe you ought to pay them more. That obviously is a very difficult decision in our employment system in the Federal Government.

Bob is very much correct, if you are not going to raise rates under your income tax, and collection issues aside, you are looking at issues regarding the tax base. The biggest tax expenditure, as you look down the list, is the exclusion for health insurance. As Bob noted, the President's proposal, which is very much like many others, like what CED is considering, would assume that the exclusion for the employer-provided premiums would be eliminated and that those resources would be used to fill some of the gaps in the health care system. It would be very difficult to restructure the health care system seriously if you did not use those resources, and frankly you would just be raising taxes somewhere else anyway. So that is a limitation on what you can do.

Another major tax exclusion in terms of revenue cost is the group of tax subsidies for pension savings. Some of those are somewhat hidden in the sense that they involve back-loaded tax preferences, which is to say you deposit an after-tax dollar today but you never have to pay tax on anything that dollar earns forever. Under those circumstances, the revenue costs in the future can be extremely substantial. That is a very generous subsidy and might require consideration.

Bob is also correct, when you get past that you start looking at items that are probably even more difficult, including the tax benefits for home ownership. I guess one thought that might be worth considering again, which was debated in the early 1980's in the course of the deliberations on what became the Tax Reform Act of 1986, was the possibility of taking some of the tax preferences in the current income tax which operate as deductions, which is to say they have the effect of what are called upside down subsidies. They are more valuable for people in higher tax brackets than in lower tax brackets. In some instances, that seems counterintuitive with the purpose of those tax preferences.

One opportunity might be to take those what are now tax exclusions or deductions, turn them into credits at a reduced rates, perhaps say the 15 percent bracket where most wage earners are. And by doing that, reduce the benefit of those provisions to people in higher tax brackets. That could be a net revenue increase. Some people might consider it a rate increase for that matter. But it is one thing that perhaps we ought to think about.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman. Thank you for holding this hearing.

Chairman CONRAD. We will get back.

OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. And I want to thank the panel. You folks have had some excellent ideas, excellent proposals, which if we are able to amalgamate and sugar off—that is a New Hampshire term. When you make maple syrup, you boil the sap and you end up with a little bit of sugar. And we could probably solve a lot of this.

Let me ask you about a couple of specifics and how we would go about implementing them because they seem to be reasonable ideas that should probably be executed sooner rather than later, even if there is not a comprehensive approach, although I would hope we would have a comprehensive approach.

The first is this idea of going to the chained CPI. Can you explain what that is and then explain how it would be implemented?

Mr. FURMAN. Sure, I would be happy to.

The official CPI uses an outdated method to calculate inflation. It uses a fixed market basket from the initial period. That assumes that people cannot substitute between different goods. The fact that we observe people changing their consumption prices when relative prices change, tells us that people, to some degree, view apples and oranges as substitutes for each other to a limited degree.

The Chained CPI is calculated by the BLS and it takes into account people's consumption patterns at both the beginning of the period and the end of the period. To the degree that people actually do substitute when relative prices change, the Chained CPI will reflect that. If you do not want to switch from health care to iPods when the price of one rises and the price of one falls, you will not actually switch from health care to iPods and the two indices will be the same.

Senator GREGG. I think I understand the concept. How would you—

Mr. FURMAN. How would you implement it?

Senator GREGG [continuing]. Legislate it.

Mr. FURMAN. It is released every month just like the regular CPI. The only wrinkle is that it is revised for up to 2 years after it is released in the way that the regular CPI is not. So the implementation would just be to switch whatever is done on CPI–W, which is the Social Security system, or CPI–U, which is the tax system, to the C–CPI–U. And then you would just—

Senator GREGG. Would that take legislation?

Mr. FURMAN. That would take legislation, absolutely. And then you would need a catch-up provision to take into account the revision to the index.

Senator GREGG. Could you do it through reconciliation, a reconciliation instruction, do you think?

Mr. FURMAN. I am not an expert on budget rules but it would certainly take legislation.

Senator GREGG. Thank you. This idea, this dependency indexing method, what is that? Go over that with me, too.

Mr. FURMAN. Sure. It is a mathematical fact in a pay-as-you-go system that whatever tax rate you have, let us say it is 10 percent, if you then have three workers for every retiree, your replacement rate can be 30 percent. Your tax rate is obviously set by statute. The replacement rate is set through the PIA factors, the thing that translates your earnings into your Social Security benefits.

What you could do is either take your payroll tax rate and when the dependency ratio gets worse it automatically goes higher. Or you could take the PIA factors—

Senator GREGG. Doesn't that mean you are raising taxes on working people? Is that not the practical effect of that?

Mr. FURMAN. I am giving you the flip side also. You can do whatever—

Senator GREGG. You know the ratio is going to go haywire, when we—

Mr. FURMAN. If you want to raise payroll taxes or if you want to cut benefits, then I believe a better way to implement that is to build the contingency in advance rather than decide today based on what the Social Security Trustees think about the future, which could be way off in either direction. This is the exact right contingency.

In terms of raising taxes—

Senator GREGG. Does it affect the benefit structure, as well as the revenue structure?

Mr. FURMAN. Absolutely. It would be up to you how to design it. You could either dependency index the payroll tax rate, or you could dependency index what are called the PIA factors.

Senator GREGG. You could do both?

Mr. FURMAN. You could do 50/50, you could do 75/25, whatever ratio on the benefit and tax side. This is a mechanism for taking any plan you might have seen that alters benefits and taxes that you may like or may not like and make it what I think we would all view as an unambiguously better plan if you built this type of contingency.

On the difference between taxes and benefits, I would add that Kevin Hassett testified to this committee last year and said "A benefit reduction is as much of a tax hike to a rational individual as an explicit tax hike." This is what Kevin Hassett said. And he explained that what matters to people is on net what they get out of the system. If you cut their benefits, it makes the existing payroll tax more distortionary than it would otherwise be in the same way that raising that payroll tax would be.

From an economic standpoint there is no difference in economic efficiency within the Social Security system of going down the tax route or the benefit route.

Senator GREGG. I would be willing to debate that with you but I do not have time.

Dr. Butler, you cited your thoughts that the dependency rate should looked at. Can you piggyback on what Dr. Furman has said?

Mr. BUTLER. Yes. I think the common thread here is that we are both saying that the commitments we are making on the benefit side should take into account the ability to pay of those on the payer side, that is the workers. That is the common theme.

I think looking at some relationship between the resources of the working population, and the demands of the retirement population, is what gets you looking at the dependency measure.

I also argued that we ought to have a further change in the indexing of Social Security benefits so that you have a reduction in the growth of projected benefits for those who are higher income workers campared with lower income workers.

Also, of course, the change in the benefit structure I argued for affects those who, as retirees, have higher income.

So all of these approaches are basically saying it is time to recognize that you the burden of the commitments that we have made is far too high because of demographic and other reasons. So in that sense, I think we are both on the same song sheet in terms of how we go forward.

Senator GREGG. You are both arguing that the benefit structure should be more of a progressive system?

Mr. BUTLER. Absolutely. I am very much on the progressive side when it comes to looking at benefit levels.

Senator GREGG. I was interested in your comments on Part D, which I am totally in agreement with. But I think my time is up.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Mr. Butler, you recommended that Social Security taxes should not be imposed on those who are employed after their normal retirement age. In the present economy, that cohort provides what proportion of our Social Security retirement?

Mr. BUTLER. I cannot answer that right now. I can get you that information. I do not know the number.

Senator WHITEHOUSE. What is your suspicion? Could you get me the information?

Mr. BUTLER. Yes, I certainly can.

Senator WHITEHOUSE. What is your suspicion?

Mr. BUTLER. As I was trying to point out, the objective here is to encourage people to spend longer in the work force if they do not need to retire. And once they—

Senator WHITEHOUSE. I understand that. I am just trying to see what the present effect would be.

Mr. BUTLER. It is a dynamic effect because you have to take into account how many people would be working beyond that point. And that, of course, will generate income taxes on those people. It is complex.

Senator WHITEHOUSE. I understand that, but just on the Social Security piece.

Mr. BUTLER. Certainly. I will do that.

Senator WHITEHOUSE. If you could start with that.

And Dr. Furman, you said in your written testimony, that two-thirds of our fiscal gap has occurred since 2001 and could have been prevented had PAYGO rules been in effect. What is the dollar number that you would connect to that?

Mr. FURMAN. We have added about $30 trillion or to the 75-year deficit in present value terms over the last 6 years, on an apples to apples basis.

Senator WHITEHOUSE. What presumptions does that make about whether those—

Mr. FURMAN. This is if the tax cuts were made permanent. If we go down the course that some have set.

Senator WHITEHOUSE. What is the present number that has been run up from 2001 until now as a result of—

Mr. FURMAN. You look at a year like this and the deficit seems not quite as terrible as it would otherwise have been. It is $745 billion worse than what was projected in January 2001 in this year. 92 percent of that deterioration is due to policy changes made since 2001. So we have added about $650 billion to $700 billion to this year's deficit through policies.

Senator WHITEHOUSE. Has that the number grown since 2001?

Mr. FURMAN. That number has grown both in dollar terms and as a share of GDP. Now some of that was unforeseen contingencies, but a lot of it was a deliberate policy choice.

Senator WHITEHOUSE. I will followup with you more on that offline, but I appreciate that.

I would also be interested in hearing from each of you, we do not have much time for it right now, but even if you could just fire me a one-pager or pick something out of an article that you agree with.

I do not understand at all well what the impact of immigration is on our fiscal situation, and to what extent new arrivals create fiscal benefit early on and then cause it—I assume that there is a profile of some kind that is the immigration effect on our fiscal situation. And I just would like to understand that a little bit better, if you can make it relatively simple. If you give me a 200 page thesis, I am not going to get through it. But if you can keep it simple, I will get through it.

Thanks very much. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

I would like to go back. I had asked Mr. Bixby and Dr. Minarik a question and I want to continue with Dr. Furman and Dr. Butler.

Is there a way of getting more revenue without a tax increase? What is your judgment on that? Without a rate increase, Dr. Furman?

Mr. FURMAN. I think that for anyone who thinks that both revenues and spending needs to be part of the solution, and I count myself in that group, it is incumbent on them to make sure that the revenue increases are as economically efficient as they possibly could be.

I agree with everything that Mr. Bixby and Dr. Minarik said, so I am not going to repeat them. Let me illustrate one of Dr. Minarik's points which was the President's Tax Reform Commission on the mortgage interest and the change they made there.

They did the worst selling job for a decent idea that I have ever seen. Everyone knows that their proposal was to curb the mortgage interest deduction. I do not think that anyone knows that 20 million middle-class Americans would have gotten a mortgage interest tax break under that proposal who do not get it today.

Chairman CONRAD. How is that?

Mr. FURMAN. They were converting the deduction to a 15 percent tax credit that was available to everyone. Right now 50 percent of middle-class Americans who have mortgage interest on their homes do not get any benefit from the existing deduction. So they were expanding it to 20 million new people.

Chairman CONRAD. Why aren't they getting the benefit of the deduction?

Mr. FURMAN. Because they take the standard deduction.

Chairman CONRAD. They probably do not even know they are not getting the benefit.

Mr. FURMAN. Some of them might be making a mistake. Many of them do not have enough mortgage interest, so they are making the right choice.

So the panel went out and, to some degree, sold this as curbing it from a deduction to 15 percent and curbing the size of the mortgage. They did not go out and say, we could make this thing work a lot better, could make it a lot more progressive. We could give a tax cut to 20 million families that do not get one today to encourage home ownership, and in the process make the tax system more efficient and save money.

I think some of these things are a matter of packaging things in the right way, especially when you do the deductions to credits. You can make it more efficient, more fair, have a lot of middle-class winners, and still, if you curb it at the top end, save money and improve the base—

Chairman CONRAD. How would the 15 percent credit apply?

Mr. FURMAN. In their proposal you would just take whatever mortgage interest you had on a mortgage up to a certain amount—$227,000 to $412,000 depending on the county. You would just multiply your mortgage interest by 0.15 and subtract that number from your taxes.

The way it works right now is in effect you take your mortgage interest and multiply it by your marginal rate, which might be 0.15 or it might be 0.35, if you are more fortunate.

So an idea like that, I think, if sold and packaged in a different way, as I said, I think could both be good economic policy and good politics.

Two others proposals to add to the list are international taxation and pigovian taxation. Our international tax system is completely broken. This is not what I am recommending, but as a thought experiment, if we completely eliminated all taxation of foreign companies on the profits they make overseas, would not have to pay any more taxes on their profits overseas, but also said they could not deduct the cost of doing business overseas from their American taxes, we would actually raise taxes rather than lower them by about $11 billion a year. International tax system serves to lower tax revenues rather than raise them. There is a lot of different ways to correct that. It gets very complicated, but it is a good area.

Finally, what economists call Pigovian taxes, taxes that correct externalities, are a way to improve economic efficiency and raise revenues. The carbon tax would be the main example. You would want to protect people. You might even want to make it a revenue neutral, distribution neutral tax reform, but that is something most economists would review as enhancing economic efficiency.

Chairman CONRAD. Dr. Butler?

Mr. BUTLER. Thank you.

When I look at revenues, as I suggested in my opening remarks, my concern is the level of taxes as a proportion of our Nation's output. I come from Europe. I have seen very high tax systems. Under current law we will move forward to higher and higher proportions in tax. I think that has to be readily understood, as opposed to changes in the baseline revenues.

When one of Joe Minarik's granddaughters gets to their middle year earnings, they will paying a burden about a third higher today as a proportion of the national paycheck. So I just want to make that point.

When one looks, however, at the issue of revenues, to some extent this is a language question. Sometimes the language is important to look at in terms of what one can do. Dr. Furman and I both support the idea of changing a current tax expenditure, the exclusion for company-provided plans. The President wants to limit this and turn it into a different structure that would give much more help to lower income people and so on. I see that as a tax reform.

But it would have the effect of reducing some of the pressures on the Government in the Medicaid program and DSH programs and so on to subsidize treatment for people, because they would have their own resources. So one can look at that as a reduction—

Chairman CONRAD. There would be some tradeoff there.

Mr. BUTLER. Yes, you could call it a revenue increase, of course, if you are only looking at one piece of it. But you can look at it as a reform, and in fact a neutral revenue reform, if you look at the whole picture.

Then also look at what I said with regard to benefits. I said let us look at clawing back some of the benefits for people who are higher income. If you do that—

Chairman CONRAD. Is this directed at Senator Gregg?

Mr. BUTLER. By clawing back some of those benefits, if you do it through the tax system some people would argue that is a tax increase. I would argue it is a benefit reduction. Some of this is semantics.

If the dollars stay in Washington then we often think of it as a reduction in spending. If we send the same dollars out and then ask for some of them back, we call it a tax increase. And yet there is no difference between the two.

So I think there is a lot of areas where a lot of this is semantical on where reform and what is a benefit reduction as a tax increase.

I think there is enough wiggle room there, quite frankly, to look at a political strategy that could make everybody feel that they are, in fact, winning in terms of moving forward.

I think that is the way to look at it. I think the wrong way to look at it is to say raising taxes is just a bookkeeping exercise. We just simply keep raising taxes because that has to be one side of the equation and ignore what has happened in Europe where we have reached a tipping point in the 1970's and 1980's where that level just got so high that we saw all of the downsides associated with it.

That is why countries like Ireland and others are actually moving to reduce taxes as a way of stimulating growth and improving their ability to pay for needed services.

Chairman CONRAD. Let me just say I do not disagree with you on the concern that you have indicated that we approach European levels of taxation. We went through this in one of our earlier hearings. We look at total tax burden in the United States. We are at about 26 percent of GDP, that is Federal, State and local. We look at Europe, they are approaching 50 percent of GDP, depending on the country. I think Germany is 36, but the Scandinavian countries are in the high 40's. If I recall, Denmark—I am part Danish—49 percent.

And yet some of these countries have higher rates of economic growth than we do. Why is that?

Mr. BUTLER. I think the first point is that you have to look at it broadly and say there is a concern about the level of taxation and to investigate the differences between different countries. There are different labor markets in different countries. In Europe there are other patterns, including the way taxes are levied. There is all kinds of factors.

But the underlying point that I was really trying to make is that we must be concerned about the level of taxation. It is rising in this country and it is rising toward these European levels. And therefore let us look at what the potential consequences are.

You look at some of the Scandinavian countries, and I think the argument is that their best days are over. That if you look at the long-haul—

Chairman CONRAD. Do not tell my friends in Denmark or Norway that their best days are over. They do not see it that way. They are very confident about their future.

Mr. BUTLER. Well, in some other countries, I suspect they may feel that their best days are over.

But still, the point I am trying to get at, I think you accept—

Chairman CONRAD. It is a legitimate point and actually a point I agree with. Senator Gregg and I, we may have a difference about where that balance point is but we share the concern. One of the reasons we have to deal with these long-term imbalances is we are headed for either tax increases that will damage our economy or benefit cuts at some point that become so draconian that it has a very adverse effect on the people we represent.

So how one reaches a balance here is an enormous challenge.

Senator GREGG.

Senator GREGG. I agree with that.

I asked both General Walker and Chairman Bernanke what percentage of GDP would be appropriate for the Government to take. Because I think when you take this down to its most basic equation, it is getting the revenues to meet the liabilities. And we know we are going to have these liabilities that are fairly significant because we are going to double the retired population. And we can obviously address benefits, and we are going to have to. And has been pointed out, probably the benefit side should be where the majority of the effort is made.

But we also know revenues are going to have to go up if you are going to maintain a stable economy and a productive economy because of the simple fact that you are going to have this huge generation that has to be paid for.

And the question becomes quite honestly, in my humble opinion, at what number do you raise revenue so high that you start to create a down cycle, where productivity falls off, where capacity for creativity falls off, where entrepreneurship falls off, where the creation of jobs fall off because people simply have a tax burden that they are not willing to undertake? Or the underground economy grows so fast that you are not generating revenues.

And it is that number at which basically you can afford a benefit structure. That will drive the process.

Neither Chairman Bernanke nor General Walker would subscribe to giving me a number. Historically, we know that 18.2 percent of GDP is what we were taking in revenues and we are now over that at 18.5 percent, and we are headed up. Historically, spending has been around 20 percent and the difference has been our structural deficit. Now spending is going to start to go up in the post-2015 period.

The question is do any of you have a number that, in your considered opinion, is reasonable relative to the percentage of GDP that can go into the government and still have the country be viable and strong economically?

Mr. BUTLER. I would say that once you go over 20 percent, you are getting into very risky territory. Of course, it does depend, I think we would all agree—

Senator GREGG. You are talking Federal Government?

Mr. BUTLER. Yes. And so therefore, that would mean total Government in the United States—

Senator GREGG. Would be around 30 percent.

Mr. BUTLER. Around 30 percent, which is getting into dangerous territory. Of course, it also depends how you levy that tax, which we all have to emphasize.

But I think also it is important to think about, when you say what is necessary for benefits, that there are all kinds of ways of enabling people to insulate themselves against the costs of bad developments in say health or retirement. We would all encourage the notion of encouraging greater savings during working lives. So that would reduce the need for Government to give such extensive comprehensive benefits.

I think other steps are possible in the health area. I work a lot in the health care area, and there are all kinds of steps you can take to reduce the probability that people will need high cost programs.

So I think it is very important not to think of this commitment on the benefit side as somehow a given, and we just have to figure out a way for paying for. There is a connection between all of these.

Senator GREGG. No, I am not suggesting it is a given.

Mr. BUTLER. I know you are not, but I think some people do.

Senator GREGG. I am simply asking a question of what percentage of GDP.

Does anybody else have an opinion on GDP burden of tax?

Mr. FURMAN. My only observation would just be from our recent history. In the 1990's the top part marginal rate, for example, was 39.6 percent.

Senator GREGG. I am not talking about rate. I am talking about—

Mr. FURMAN. I understand. And tax rates were such that you would collect 2 percent of GDP more than what we are collecting today. I am not saying we should go back to exactly the tax structure we had in the 1990's, but that tax structure, which would be about 2 percent of GDP higher than we are right now, was clearly compatible with a very successful economy.

Senator GREGG. I would have to debate that a little bit because we had the Internet bubble, which was the most unique bubble in the history of the world and generated a huge amount of paper gain that did not exist, which generated a huge amount of revenues to us which I do not see us getting again no matter what rate we had.

But the question is is 22 percent, which is what during that Internet bubble 22 percent of revenue? We got to, I think, 21 percent of the gross national product being Federal revenues.

Mr. FURMAN. It also fluctuates because of the economy. In a good year the economy should collect more. That is part of why it is disappointing that we are so low, so close to average this year when the macro economy is doing so well. It should go up as a share of GDP in a good year and down in a bad year.

Mr. MINARIK. Senator Gregg, Jason mentioned earlier, I think, an important point which is for whatever level of revenues you are going to collect you want to collect them in the most efficient way possible. The percentage of GDP that we take out of the economy in total could be done any number of different ways. There are more efficient ways and less efficient ways.

We just said goodbye to Richard Musgrave, who was the dean of the public finance discipline within economics. One point that he made in his textbook, his monumental textbook on the subject, was you can perhaps collect more revenues in total with lower distortions by using several different mechanisms to collect the revenues rather than loading them all on just one.

So some would argue, for example, I did not get to talk about it, but the Committee for Economic Development has suggested that we need a supplemental value added tax to try to raise more revenue at the Federal level with lower total distortions. One could argue that you might be able to raise somewhat more revenue with a value added tax, in addition to an income tax, than attempting to raise the same amount of revenues out of that income tax. That is one possible argument.

Senator GREGG. We had testimony last week where somebody, I have forgotten who it was, said that the value added tax had as poor a level of collection or even a worse level of collection in Europe that the income tax has, as far as avoidance.

Mr. MINARIK. That point has been debated. There are problems of collection with any tax. One argument that has been raised, you can go on two sides of this particular argument. One is that if you have the States collecting a sales tax and the Federal Government collecting a value added tax, the collection efforts at the two levels of Government will actually have synergies and they can both be more effective. Some others argue that you have a clash between the revenue needs at the State level and the revenue needs at the Federal level. That would cut the other way.

Clearly any tax has issues of collection. Our income tax has issues of collection. We have all sorts of issues of reporting. We have issues at the border. So nothing is going to be easy.

Senator GREGG. That is true, and I guess my own personal experience, being from New Hampshire, which is surrounded by States with both a sales and an income tax and we have neither, is that most of the States that have moved to a sales tax have done so with a representation to their citizenry that the income tax would be cut or reduced. And after about three or 4 years of stable income taxes, their income taxes start to go back up, even though they have a sales tax added.

But the first thing I was taught when I arrived here, by one of most brilliant people I ever served with, Barber Conable, was that all Government moves to the left. The issue is how. If you think of it as a railroad train, the question is how many engines do you have on the train and how fast is it going to go? And the number of revenue collection mechanisms you have defines the number of engines.

But that is a debate for another time.

I would ask one last question. You said you wanted a 3 percent retirement savings vehicle on top. Was that on top of the payroll tax?

Mr. MINARIK. That is correct, Senator.

Senator GREGG. Where you would have a 15 percent payroll tax essentially, or 15 percent withholding and 3 percent of it would go into a savings account?

Mr. MINARIK. The payroll tax would remain as it is today.

Senator GREGG. Thank you. I appreciate that.

Chairman CONRAD. Let me go back, in my final round of questioning, to this question of reform. Dr. Butler, we have sort of begun that conversation. I would like to include everybody.

Any proposals on tax reform? Dr. Minarik, I was very interested in what you were just discussing. Dr. Butler, you were hearing what Dr. Minarik was discussing there in terms of diversifying our tax base and basically having an income tax that would be supplemented by a value added tax. Does that make any sense to you?

Mr. BUTLER. I do not support a value added tax, because of the reason that Senator Gregg pointed out. Those who argue it should be a replacement and a more efficient way of raising taxes ignore that we always seem to end up with both. That was certainly the case in Europe.

I think that there is also other issues associated with the value added tax in terms of its implementation, and its regressivity. It then also means that tax costs have to be factored into services of government. Costs of various services that people are paid for by government. It is a complicated way of doing it.

I actually favor much a reform toward a more standard expenditure tax through the income tax system, with lower rates, a much wider base of taxation, and elimination of double taxation. But through the income tax itself. I think it is a way—

Chairman CONRAD. Could you describe that a little more fully?

Mr. BUTLER. Just very simply that we would take steps to make taxable, many of the items that are currently tax free fringe benefits, such as the tax exclusion for company-based health plans.

Chairman CONRAD. Broadening the base.

Mr. BUTLER. Broaden the base and lower the rates, which I think will be much more efficient.

Chairman CONRAD. Better in terms of the economic effect.

Mr. BUTLER. Yes, but I within that structure, as opposed to a value added tax system, it is much easier to say people below a certain income will face a lower burden. And it is much easier to do that through an income tax system than to say people are paying all that heavy value added tax so we will have to try to figure out some way of giving them a credit against the taxes they paid. Well, how much tax did they pay? And so on. So I think an income tax based system, if reformed, is in my opinion much more economically efficient, easier to administer, and fairer than something that has these different forms of taxation that you are trying to link together and somehow make sure that any one individual in different situations is treated equitably. I think it is much harder to do that.

Chairman CONRAD. Dr. Furman?

Mr. FURMAN. Your question is to talk about a VAT?

Chairman CONRAD. I am really interested in the what Dr. Minarik started the discussion. Dr. Butler had talked about reform proposals. Does it make sense to you to have a VAT as a supplement to an income tax? What are the things we should be thinking about?

As you know, there are a lot of discussions swirling around here about how we deal on both the revenue side and the spending side of this equation. But on the revenue side for the moment, reform ideas that you would have.

Mr. FURMAN. To comment on the VAT, it is something that I think is worthy of serious consideration. My recommendation is if we decided to do a VAT to raise revenues it would not make sense to do a small one, say a 3 or a 5 percent VAT on top of the existing income tax because you would get an additional layer of complexity associated with the VAT and the paperwork and you would still have all of the same complexity in the income tax system.

If you go down that route, I think you should do, a bigger VAT and take a lot of people off of the income tax, with appropriate credits on that side. So that when you are adding this new system, you are greatly simplifying the old system for a lot of people.

Chairman CONRAD. One of the ideas that is being discussed is something along those lines, where you would take off a significant majority of people from the income tax system altogether. They would not have to file tax returns anymore.

Mr. FURMAN. This is a proposal Michael Graetz at Yale has made. There are a lot of things to be worked out in that proposal because a lot of low-income families are getting the Earned Income Tax Credit and the Refundable Child Tax Credit. I do not think his proposal has worked them out, so I would not recommend going down that route.

A good general principle is that we should take advantage of the introduction of a new tax, if that is what you are doing, to simplify the old tax system. One of the ways of simplifying it would be taking more people off of it.

That would be my thoughts on a VAT. And then more broadly, we should think about tax expenditures and the conversion from deductions to credits, the reform of the international tax system, efficient Pigovian taxes, and something we have not gotten into at all, which is that our business tax system as a whole is very much broken. We keep adding things that make it so that you do not need to pay taxes on income at any level of the system. Even in a consumption tax. If that is what you believed in, you would not have interest being deductible for companies in the way that it is today.

We have a really incoherent system that supporters of an income tax or a consumption tax would reject in the context of business taxation. And that is another area that is very important.

Chairman CONRAD. If we had following goals: we need to raise the revenue that we need to meet the needs of a reformed entitlement system, and by reformed I mean obviously we have to save serious money there. At the same time, we wanted to simplify the tax system. We have had a lot of estimates given to the committee of how much is being spent for people to comply with the current income tax system. If we wanted to simplify, if we wanted to make it as economically efficient as possible, that is we wanted to put America in the strongest position we could be in competitively in terms of our tax system, what would you advocate as a tax system?

The current one, reformed by reducing the base? A VAT? Some other reproach? I would be interested in each of your—Dr. Butler, thoughts that you might have on this.

Mr. BUTLER. As I said, assuming you wanted to raise revenue, than taking that as an assumption I think a much simpler form of the income tax with a broad base, reducing incidences of double taxation as far as possible, factoring in all forms of compensation, and then giving appropriate exemptions or partial exemptions to people who really need it in order to obtain adequate income would be the right way to go. I think that is simpler. I am very concerned about these notions of value added taxes and other taxes which I think are complex. They only try to approximate what you can get from a much flatter broader income tax. But these other approaches have, I think, endless problems associated with them.

Chairman CONRAD. All right, Dr. Furman.

Mr. FURMAN. Sure, and before I sketch that, we have been talking about making the tax system more efficient. I think that is very important. But I would also say if you had to, for example, raise the top rate back to 39.6 percent, that is completely compatible with a thriving economy. Steps like that, if you are not able to undertake a more comprehensive tax reform, would raise more revenue and be good for the economy in the long run because they would bring the deficit down.

In terms of a tax reform, I guess a lot of us are in agreement here that you take our existing income tax system and broaden the tax base. I agree with Dr. Butler that you do not want to double tax business income, but we have an awful lot of business income that is not being taxed at all right now.

Chairman CONRAD. Why is that?

Mr. FURMAN. For a number of reasons, but basically companies get to deduct their interest and then pay out a lot of their profits in the form of dividends which are taxed at very low rates or not taxed for people who have tax preferred accounts. That is one type of reason.

Another would be a whole bunch of loopholes built into the corporate tax system.

The fundamental reason is that we have something that is half a consumption tax, half an income tax, and they are a very incoherent hybrid that I do not think any economist would want to defend or explain even.

Broadening the base in the personal income tax, reforming the taxation of business income and the international tax component plays an increasingly important role in that. Then, to the degree that you are adding new taxes, add ones that we think are simple and economically efficient. So with carbon taxes, possibly think about a value added tax if you can use it to simplify the income tax.

Chairman CONRAD. Dr. Minarik?

Mr. MINARIK. I have stored up a couple of observations that I think are pertinent to this.

Going back to Senator Gregg's original question, and you are asking about revenue sufficiency, what percentage of GDP can we collect without adverse economic consequences? I guess one answer to that question is some meaningful margin less than the next guy. And if you think in those terms, the U.S. public sector is significantly smaller than anywhere else around the world. So we have some room to maneuver.

Chairman CONRAD. Other than Japan, I might say.

Mr. MINARIK. Japan is the closest. They, of course, have no national defense sector to speak of, so that is one reason why there is a difference there. But beyond Japan, you—

Chairman CONRAD. That is about it.

Mr. MINARIK. That is about it. And of course, if you want to trade the U.S. economy for the Japanese economy right now—I will take the other side of that deal.

That was one question that was pertinent. Again, in thinking about how much revenue we need, Senator Gregg's observation was well, Government expands to fill the taxes you have. It is 2007. Senator Gregg's assertion would imply that we would have balanced budgets most of the time. In the last 50 years, we have had four balanced budgets. So nine times out of 10 we have been spending beyond the revenues we have.

So the notion that having revenue sufficient to pay for the Government that you have right now is going to encourage higher spending, I think suggests that really the Congress and the administration just have to do their jobs to keep things within the limits.

Stuart suggested the notion of what he called a reformed income tax, which I think is what many people would call a consumed income tax. There was an example of an attempt at that a number of years ago, the so-called Nunn-Domenici proposal, which was formulated under the aegis of the Center for Strategic and International Studies here in town. Senator Nunn and Senator Domenici worked together on it.

One of their chief technical advisors was Rudy Penner of the Urban Institute. If you ask him about that experience, he will tell you that he went into it as an enthusiastic supporter of the notion of a consumed income tax. He finished it with the notion that there was no way that was ever going to happen.

There are a lot of technical issues involved there, including but not limited to the question of how you try to accommodate everyone who under the current system has some kind of a tax break and is going to want it to be translated into the new system.

You can look at just about any possible tax, come up with a pristine version of it that will look attractive, and then try to make it real and run into a lot of problems.

Just to be a little bit more complete about what CED discussed in its document which was released early last year, we did advocate broadening the base of the income tax while reducing the rates that would be imposed. A 10-percent value added tax, Jason is exactly right, your administrative ante to have a value added tax is the same whether the rate is 1 percent or 10 percent, you might as well get some money out of it.

Stuart is correct, that it is not easy to provide low income relief to compensate for the value added tax that you are collecting. That is simply a problem that we have to accept. For 30-some years now we have had an Earned Income Tax Credit. One side observation, we created it in part as a substitute for increasing the minimum wage. That notion was we wanted to make work pay for people with low incomes. We did not want to impose that on their employers. We thought that would be economically disruptive. So we created an Earned Income Credit. Nothing is free. You have to pay for that to make it work. But that, I think, is acknowledged. It has to be a problem but it is a necessary ingredient if you want to have that kind of benefit.

Personally, I think that we are getting to the borderline where it will be very hard to raise under the income tax the revenues that we will need with demographic change, even assuming that we can freeze in its tracks the rate of health care cost per beneficiary under Medicare. Health care costs through the economy are growing 2.5 percentage points per year faster than GDP. So that is going to be a problem.

We are going to need more revenue. We will have to decide whether we can get that revenue out of our existing institutions. If we are going to do that, we have to increase their efficiency substantially. If not, we are going to have to look somewhere else. A value added tax is one possibility. A carbon tax is another possibility.

One other footnote and I will close, either a value added tax or a carbon tax might look regressive and would be regressive taken on its own. If revenues from either of those taxes were devoted to financing a reformed health care system which would provide universal coverage, the combination of a health care benefit and one of those regressive taxes for low income people would probably, in the final analysis, look much more progressive because you would be removing that burden of paying a health insurance premium.

Health insurance premiums are virtually the same per person or per family up and down the income scale. A person with a very high income would pay much more in value added tax than the value of the health insurance premium he is getting. A person with a low income, it would be the reverse. So put those two together and you might be able to get a progress result out of what would look like a regressive tax.

Chairman CONRAD. Let me just say, one of the things that we have had testimony before the committee on tax scams that are occurring, especially offshore. In the tax gap hearing one of the recommendations, a very strong recommendation, that came from that panel is that you need to have international reporting because all countries are suffering from—I held up a picture of a building in the Cayman Islands, a five-story building, that is the home to over 12,000 companies. It is a very efficient building.

They all say they are doing business there. They are not doing business there. They are engaged in tax scams there. What they are doing is showing profits in subsidiaries located there because they do not face taxes and they are shorting all of the other countries and, in effect, shorting other companies. Because other companies that are domiciled here do not engage in that kind of scam.

How about reform in an area like that? I assume that nobody would object to closing off that kind of taking advantage of the system. Mr. Bixby, does your group have a position on that?

Mr. BIXBY. It is not an area that we have looked at very closely but nobody could have any objection to closing down tax scams, and I think they certainly—the IRS has been relatively aggressive in that area recently but clearly there is more work to be done. I certainly think that that is an area that you could get into and there would probably be a great deal of public support for it as well.

But I think getting into a real tax reform initiative would be a good thing to do in the context of looking at these challenges. And you have the vehicle. Aside from what you mentioned, we have the AMT issue out there which is really the big driver for a tax reform debate because it is so big and there is a broad bipartisan consensus that it needs to be addressed, that I think it really could be the engine that drives a major tax reform initiative like we had in the 1980's.

And you can get into these issues about the tax gap. You can get into the issues about the tax scams. You can also get into the issues about closing these major tax expenditures that people do not even necessarily realize our—I like to call them tax entitlements because that is really what they are. But they ought to be on the table.

And the President has put one the major ones on the table. So you sort of take that in combination with the upcoming AMT debate and it does provide an opportunity.

I would agree with Jason and others that if you are looking for a new forum and do not want to raise rates right now, the carbon tax idea, or raising the gas tax, I know that is not popular. But environmentally friendly taxation is another way that you might be able to get into a revenue debate that has ancillary good effects for the long-term of the environment.

To top it off, no pun intended, I would endorse Jason's idea also of imposing a top rate. A lot of the revenue boost that we are getting right now seems to be coming from upper income, more income being into the upper range.

I think reimposing a higher, slightly higher, or going back to the 1990's top rate, would bring in some needed revenues. I cannot imagine it would do too much to damage the economy. But that is not tax reform. That is just a good old fashioned tax increase.

But I think the more opportunity areas are to really get into the tax expenditure debate, the tax gap issue, and the possibly of environmentally friendly taxes.

Chairman CONRAD. All right. Anybody with a closing thought? Anybody that wants to have something that they wanted to contribute that we have not had a chance to get on the table? Dr. Minarik?

Mr. MINARIK. Just one thought, Mr. Chairman. To a certain extent when we think about taxes in this connection, realistically speaking, and I went into this in my written statement but did not get there, you can tax me now or you can tax me later. But one time or another you are going to do it.

If you do not do what you have to do to keep budget deficits under control and ideally run surpluses for a while before the retirement of the baby boom starts, if you pay the taxes later, you are going to pay them with interest. So you might as well stay current if you can do that.

Another observation, thinking about interest, you hear a lot of people say that they are suspicious of Government because they feel like they pay taxes and they do not get anything in return. Well, if you are paying taxes to pay interest on the debt, that is literally true. You are not getting anything in return.

And the longer you allow deficits to run, the larger your deficits get, the more taxes our succeeding generations are going to have to pay just to keep the Acme Collection Agency from backing up the truck to the White House to collect the furniture. That is an important, I think, piece of reality that we have to keep in mind.

Chairman CONRAD. Dr. Butler.

Mr. BUTLER. I would just like to add that we have not actually spent any time talking about the budget process itself, in terms of how to force action on these issues. I suppose this is almost a question to you, actually.

I want to stress of the importance that I feel, and I think all of us probably feel, of disclosure of the full scale of the unfunded obligations of the Federal Government. It is something, of course, that Comptroller Walker is very concerned about, as we are, and supports taking active steps to do that.

And also the notion of saying that the entitlement spending should not just be on automatic pilot but should be budgeted in a serious way to force serious discussions about the relative balance of expenditures in that area, expenditures in other parts of the Federal Government, and revenues. That it should be done in an explicit way rather, as I pointed out in my testimony—

Chairman CONRAD. Indirect.

Mr. BUTLER. Automatic preemption of some big chunks of spending is the problem we are talking about, which we do have to look at and consider. Yet every day we are trying to find ways of paying for our troops in Iraq.

Mr. BIXBY. I just would want to emphasize something that I mentioned at the beginning and Dr. Butler mentioned it as well, which is I think this is an issue that really needs more public attention, and of course you are doing everything you can on the committee to draw attention to it with this series of hearings. But a major public education, public engagement effort is needed on this. We are doing this Fiscal Wake-Up Tour, all of us. Jason has not been out on the tour yet, but he has volunteered for it and the rest of us have been out on this.

I would invite members of the committee to join us in their home States and maybe do some home and home series, as what I have thought about. Maybe a Republican, say for example Senator Gregg, and yourself, cosponsoring one in North Dakota and one in New Hampshire and drawing some public attention to this issue.

What we find on the Fiscal Wake-Up Tour is that people love to hear a discussion like we have had today, people exchanging ideas, not name calling, not pointing fingers at one another or casting blame, but talking about a problem, agreeing on the size of the problem, agreeing that there are no easy options and sort of debating what the tradeoffs are. Facing the magnitude of the problem and the nature of the tradeoffs and getting everybody to understand that is really, really important. That is what we try to do in the Fiscal Wake-Up Tour and it has been getting some attention.

Anything that we can do—because we think we are helping you. This is helping you and Senator Gregg and all of the members of the committee explain the problem to the public and perhaps to some of your colleagues.

Chairman CONRAD. Let me just say, obviously if the public does not understand, there is going to be no sense of urgency and no pressure on our colleagues or the White House to act. I think everybody in this room knows, certainly everybody on this panel knows, this is a situation that is unsustainable. It just is. And the faster we deal with it the better, the less draconian, the solutions will have to be.

It is extremely difficult to get a sense of urgency when the roof is not caving in. You have relatively good economic news, deficits are going down somewhat. Of course, nobody mentions the debt is going up. It is very hard, and I guess it is deep in human nature, to put off making unpleasant choices when there is no crisis.

The problem is by waiting, by failing to act, we make the crisis to come worse. That has been the overwhelming testimony before this committee. It is as clear as a bell. I do not care what projection you use. Anybody who thinks this is a matter of projections, fundamentally it is not. Because the baby boom generation is not a protection. They have been born. They are alive today. They are going to retire. They are going to start retiring soon.

And it fundamentally changes what we have had as an experience in the past. I think that is one reason it is very hard for our colleagues to get their minds around this. It is different than past experience.

And so I think an awful lot of people are kind of hoping against hope this goes away. It is not going to go away. You can say when is it going to really start crimping? You can debate that. But the fact is we are on an unsustainable course.

You have helped us, I hope, make that more plain today. And for that we are very grateful. I thank this panel and we will stand in adjournment.

[Whereupon, at 11:52 a.m., the committee was adjourned.]

Responses to Senator Whitehouse on Social Security
March 6, 2007

1: "Mr. Butler, you recommended that Social Security taxes should not be imposed on those who are employed after their normal retirement age. In the present economy, that cohort provides what proportion of our Social Security retirement?"

Eliminating Social Security payroll taxes for workers who are employed after their normal retirement age (NRA) would help to increase labor force participation at a very low cost. NRA is the age at which a worker can receive his or her full Social Security benefit. Workers born before 1937 can receive full benefits at age 65, while those born after 1937 have an NRA that ranges between age 65 and 67.

The Social Security Administration (SSA) estimates that about three percent of employed workers are over the age of 65. Two percent are between 65 and 69, while a further one percent is employed and over the age of 70. In 2003 (the latest data available), workers over the age of 65 paid 2.72 percent of all payroll taxes. 1.66 percent came from workers between the ages of 65 and 69, and an additional 1.06 percent came from workers over the age of 70.

A November 2006 working paper for the University of Michigan Retirement Research Center, "Taxes, Wages and the Labor Supply of Older Americans" by Lucie Schmidt of Williams College and Purvi Sevak of Hunter College (available at: http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp139.pdf), found that such a policy could increase the proportion of workers over age 65 who remain employed and the number of hours that they work. The authors found that a tax change that increased pay by about 10 percent would increase labor force participation by 7.9 percent among men and 4.9 percent among women. Hours worked would increase by 5.3 percent for men and 3.6 percent among women.

The econometric formulas used by the authors estimate increases due to this policy change, but not that participation would increase from one number to another. According to the Bureau of Labor Statistics, 21.9 percent of workers between the ages of 65 and 74 were employed in 2004. The agency estimates that in 2014, that number will climb to 26.9 percent.

While allowing workers who are employed past their NRA would reduce Social Security payroll tax revenues by about 2.72 percent, increased income taxes on the additional earnings caused by the policy change would allow government revenues as a whole to replace at least some of that money.

2: "I do not understand at all well what the impact of immigration is on our fiscal situation, and to what extent new arrivals create fiscal benefit early on and then cause it—I assume that there is a profile of some kind that is the immigration effect on our *fiscal situation. And I just would like to understand that a little bit better, if you can make it relatively simple."*

Immigration will affect Social Security's solvency in two ways. First, the number of immigrants who enter the US workforce each year affects the productivity figures for the economy as a whole. Those numbers are the basis for the programs that estimate Social Security's overall fiscal situation. Second, both payroll taxes paid by immigrant workers and benefits eventually paid to them affect the program's finances.

A simple way to calculate economic growth is to multiply productivity changes times the change in the size of the workforce. Thus, adding more workers to the economy, whether by younger people graduating and going to work, people who have been unemployed or otherwise out of the workforce going back to work, or new immigrants going to work, helps to improve the growth rate.

The combination of baby boomers getting older and preparing to leave the workforce and the dropping birthrate has increased the importance of immigrants in sustaining growth. The President's Council on Economic Advisors has estimated that between 1996 and 2003, nearly 60 percent of employment growth came from immigrants. In order to understand and accurately forecast the long term changes in our economy, it is important that economists correctly estimate the number of immigrants who will join the US workforce each year.

For Social Security as a specific program, increased immigration improves the system's finances in the short run by paying more payroll taxes. SSA's Office of the Chief Actuary estimates that increasing the annual number of legal immigrants who join the US workforce by 250,000 would improve Social Security's finances by about 5 percent over the 75 year planning horizon used by SSA.

However, SSA's model may also hide the eventual cost of paying those workers benefits. Because immigrant workers are typically younger than the rest of the workforce, the payroll taxes that they pay may fall within the 75 year planning window, while the benefits that they will eventually be paid may fall outside of it. For example, a 20 year old immigrant who joins the workforce in 2007 will probably begin to receive benefits by 2054, well before the 75 year period ends in 2082, but retirement benefits paid to 20 year old immigrants who join the workforce after about 2017 will fall outside the planning period.

Finally, there is the difference between legal and illegal immigrants to the system's finances. Legal immigrants pay taxes and receive benefits the same way that native born workers do. Illegal immigrants are barred by law from receiving Social Security benefits. However, because they often either use a false Social Security number or "borrow" someone else's number, illegal immigrants almost always pay Social Security taxes.

Because illegal immigrants are essentially paying payroll taxes without the hope of receiving benefits, those taxes improve Social Security's finances by a slight amount. SSA accounts for tax receipts that they cannot assign to a legal worker's record in a suspense file, where they remain unless they can later be assigned to the earnings record of a legal worker. If illegal workers ever become legal residents, whether through an amnesty or some other means, and can prove that they paid Social Security taxes, then they would become eligible for benefits.

The Social Security Advisory Board did a study of the effects of immigration on Social Security and ways of better forecasting immigration in December 2005. The study, Issue Brief #1: The Impact of Immigration on Social Security and the National Economy can be found at: http://www.ssab.gov/brief-1-immigration.pdf.

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CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2008

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COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

February 1, 2007—THE CURRENT ACCOUNT DEFICIT AND THE U.S. FOREIGN DEBT

February 6, 2007—WAR COSTS

February 7, 2007—THE PRESIDENT'S FISCAL YEAR 2008 BUDGET PROPOSAL

February 8, 2007—THE PRESIDENT'S FISCAL YEAR 2008 BUDGET AND REVENUE PROPOSALS

February 13, 2007—THE PRESIDENT'S FISCAL YEAR 2008 BUDGETARY PROPOSALS FOR THE DEPARTMENT OF HEALTH AND HUMAN SERVICES

February 14, 2007—THE PRESIDENT'S FISCAL YEAR 2008 BUDGET PROPOSALS ON TAX COMPLIANCE

March 1, 2007—THE PRESIDENT'S DEFENSE BUDGET REQUEST FOR FISCAL YEAR 2008 AND WAR COSTS

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THE CURRENT ACCOUNT DEFICIT AND THE U.S. FOREIGN DEBT

THURSDAY, FEBRUARY 1, 2007

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, Cardin, Sanders, Whitehouse, and Gregg.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. I will bring the hearing to order.

Senator Gregg has indicated he has been called into another meeting momentarily, but he will be here shortly and other members are on their way, as well.

I had one of our colleagues who is on the committee come to me yesterday and said you know, we are just having kind of a crash landing here with the early days of the session. He said he had three hearings simultaneously this morning and wanted to know if we could defer ours. I said no, I do not think that will work.

That is happening to us, but other members will come as they are available from other hearings.

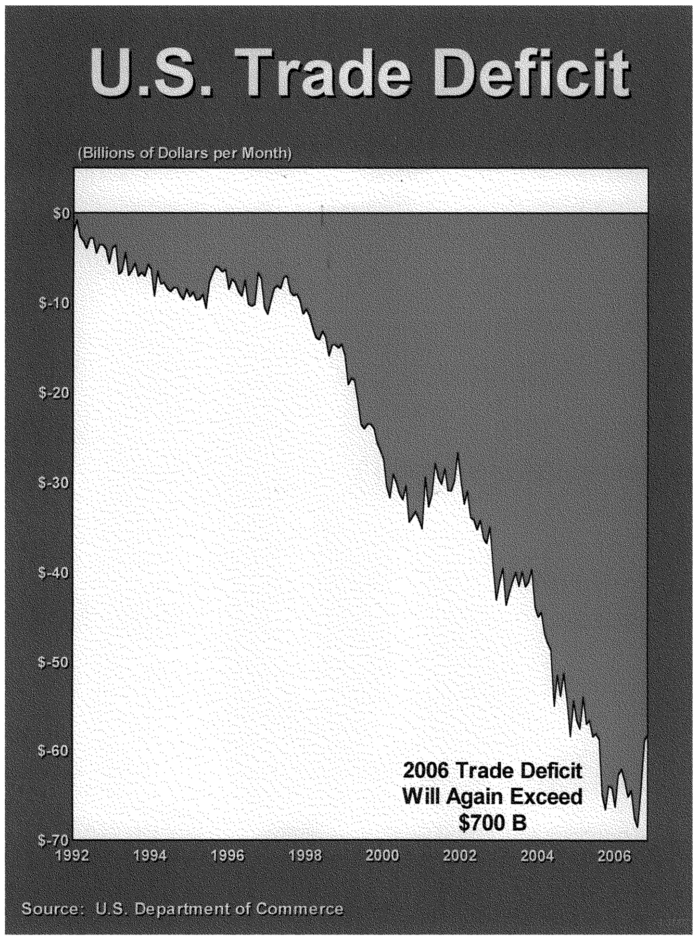
Given the backlog of work from the last Congress, usually we start out with a little more calm, but not this year. So it is what it is.

I want to particularly welcome our witnesses here today. Dr. Fred Bergsten is somebody who has testified before this committee before, and we are delighted to have him back, the Director of the Peterson Institute for International Economics; Dr. William Cline, Senior Fellow at the Peterson Institute; and David Malpass, Chief Global Economist at Bear Stearns. Welcome to you all. We deeply appreciate you taking your time, extremely valuable time, to come before this committee and help us try to make the case of the importance of dealing with these long-term fiscal imbalances.

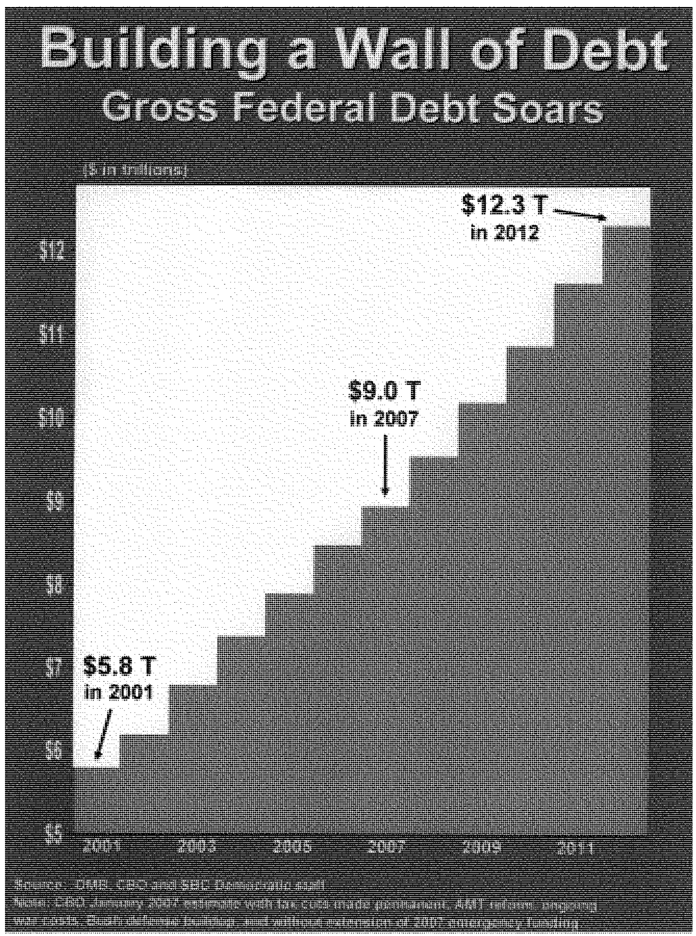
As you know, Senator Gregg and I have been urging our colleagues to develop a process by which we would produce a plan, a bipartisan plan, to address these long-term fiscal imbalances. We believe it is very important.

Today's hearings focus on the danger of the twin deficits, that is the Federal budget deficit and the trade deficit. Both of these deficits pose a serious threat to our Nation's long-term economic security.

Although the U.S. trade deficit has fallen recently, we can still see that the trade deficit in 2006 will exceed $700 billion.



At the same time, our annual budget deficits are contributing to the wall of debt that we now face. At the end of 2001, our gross Federal debt stood at $5.8 trillion. At the end of this year CBO tells us, the Congressional Budget Office, tells us it will be $9 trillion. And if we continue current policies, gross debt will reach over $12 trillion by 2012.



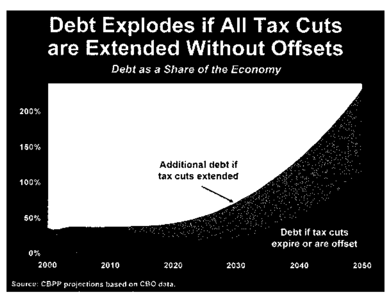
I might say this is at the worst possible time, right before the baby boom generation retires.

We are having a very difficult time. Let me be very frank, we are having a very difficult time persuading our colleagues and the Administration of the need for urgent action. In a way, I think people are being lulled to sleep by the somewhat modest reduction in the deficit. While the deficit has shown some relatively slight improvement, the debt continues to mount in a way that is really unfavorable over the long-term, especially in light of the demographics of the country. That is what I think we are having a hard time getting people to fully grasp.

This demographic tsunami that is coming at us is unlike what we have faced in the past, and so I think it is hard for people to get their minds around that.

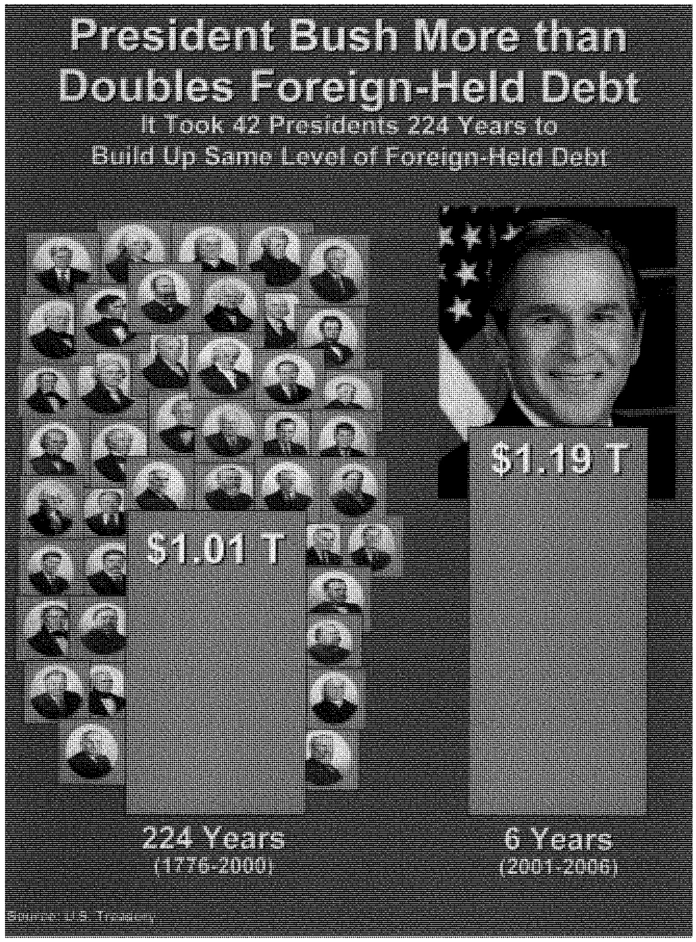
Over the long term, we can see the Nation's gross debt will continue to explode if all the tax cuts that the President has supported are extended without offset. In fact, according to the Center on Budget and Policy Priorities, it will more than double our debt level as a share of GDP by 2050 if all of the tax cuts are extended without offsets.

This chart shows how the debt grows, in the case of the tax cuts expiring or being offset. That is the green part of this slide. That is what happens to the debt if the tax cuts expire or are offset. That is the green part of this.



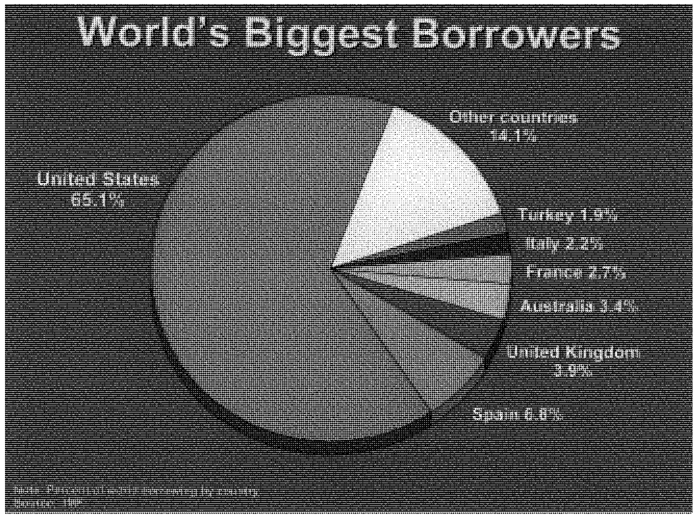
The red is what happens to additional debt if the tax cuts are extended without offset. As much as I would love to support every tax cut and every spending program, you know, as a politician there is nothing better than being for every tax cut and every spending program. The problem is we cannot continue to do this. We cannot continue to do this.

Let me go to the next slide, if we can. The result of all of this is we are becoming increasingly dependent on the kindness of strangers. We are building up foreign holdings of our debt at a dramatic rate. It took 42 presidents, all of the presidents pictured here, 224 years to run up $1 trillion of debt held externally. This president, on his own, has more than doubled that amount in 6 years. This is an absolutely unsustainable course.



And here are the top foreign holders of our national debt. We owe Japan now more than $600 billion. We owe China more than $300 billion, the United Kingdom more than $200 billion, the oil exporters almost $100 billion. And my favorite, the Caribbean banking centers. We owe the Caribbean banking centers over $60 billion.

We are now by far and away the world's largest borrower. In 2005, the United States was responsible for 65 percent of all world borrowing by countries, 10 times as much as the next largest borrower. We may be starting to see the ramifications of all of this debt.



Last September the Wall Street Journal reported that the World Economic Forum downgraded the United States from the most competitive economy in the world to the sixth most competitive. They stated, "serial budget deficits in the United States have led to rising public debt, which means an increasing portion of Government spending goes toward debt service. That means less money is available for spending on infrastructure, schools or other investments that could boost productivity. Heavy Government borrowing, which means competing for money and financial markets with the private sector, also tends to drive up businesses' borrowing costs."

THE WALL STREET JOURNAL.

WEDNESDAY, SEPTEMBER 27, 2006.

Economic Forum Warns U.S. Of Budget Deficit's Ill Effects

By MARCUS WALKER

The U.S.'s huge budget deficit threatens to make the country's economy less competitive, according to a study by the World Economic Forum, an institute in Switzerland.

The institute's annual study of global competitiveness says the U.S. economy is the sixth most-competitive in the world, slipping from first place in last year's ranking, a result of mediocre scores for its public finances.

Switzerland ranks No. 1 in this year's survey, thanks to what the forum sees as a combination of efficient public administration and flexible markets. Three Nordic countries—Finland, Sweden and Denmark—come next, followed by Singapore and the U.S.

The competitiveness study ranks countries according to a range of criteria—including macroeconomic policies, market regulations, technological development, education systems and public institutions—that the forum believes influence an economy's level of productivity, and thereby its ability to sustain economic growth over many years. The ranking combines economic indicators with the findings from a survey of business executives.

"The U.S. remains a very competitive economy," said Augusto Lopez-Claros, the forum's chief economist. "It leads in innovation and patent registrations, has some of the best universities in the world, and it has extremely high levels of collaboration between universities and industry," he said. "However, how you manage your public finances is very important."

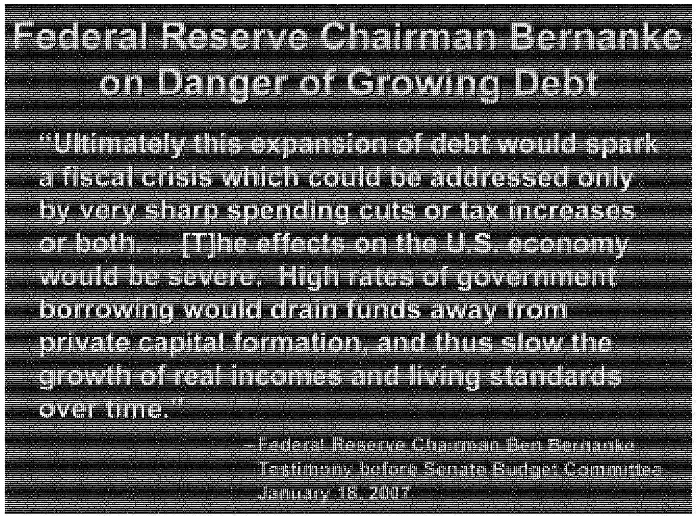
Serial budget deficits in the U.S. have led to rising public debt, which means an increasing portion of government spending goes toward debt service. That means less money is available for spending on infrastructure, schools or other investments that could boost productivity. Heavy government borrowing, which means competing for money in financial markets with the private sector, also tends to drive up businesses' borrowing costs.

Middling scores were awarded to the fast-growing emerging economies of the world considered to be changing the economic balance of power: India ranks 43rd out of 125 countries in the survey, China ranks 54th, Russia 62nd and Brazil 66th.

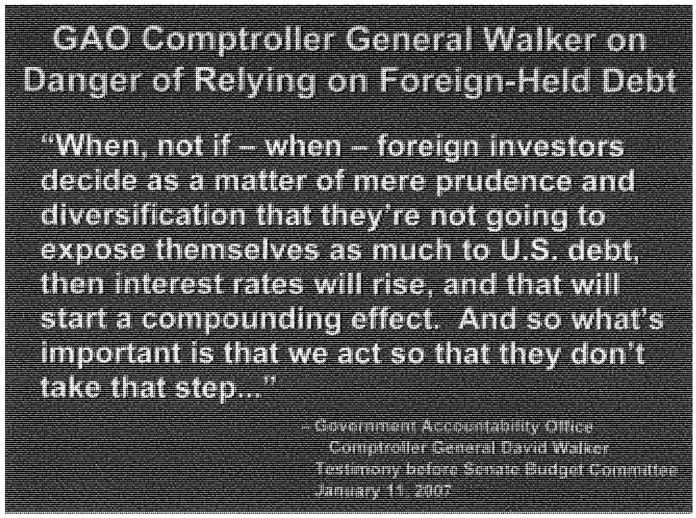
Russia and China, despite good scores for macroeconomic management, are marked down for a lack of transparency and even-handedness in their public institutions, including their bureaucracy and judiciary, and for protections for property rights. Brazil is making progress on improving its public finances, but at too slow a pace, according to Mr. Lopez-Claros. Of the four countries, only India improved its ranking in the survey this year.

Although many economists and investors believe economic output in these four countries will overtake that of most of the world's established economic powers by midcentury, the World Economic Forum warns that the emerging economies' growth could hit barriers unless they develop more-efficient public institutions.

In testimony before this committee last month the Chairman of the Federal Reserve, Chairman Bernanke, emphasized the dangers of this growing debt. He said ultimately this expansion of debt would spark a fiscal crisis which could be addressed only by very sharp spending cuts or tax increases or both. The effects on the U.S. economy, he said, would be severe. High rates of Government borrowing would drain funds away from private capital formation and thus slow the growth of real incomes and living standards over time.



Our increasing reliance on foreign debt poses an added threat to the economy. Here is what the head of the Government Accountability Office told this committee last month. "When, not if—when—foreign investors decide as a matter of mere prudence and diversification they are not going to expose themselves as much to U.S. debt, then interest rates will rise, and that will start a compounding effect. And so what is important is that we act so that they do not take that step.”



We have already seen the potential impact on our economy from the investment decisions made by foreign holders of our debt. Here is a Financial Times article from last November on the value of the dollar falling after a comment from a Chinese bank official on the need for China to diversify its foreign exchange reserves. The paper stated, and I quote, "The dollar was sent tumbling on Thursday after the Governor of the People's Bank of China said the country was considering lots of instruments to diversify its foreign exchange reserves." Just that comment sent the dollar down.

WEEKEND
FINANCIAL TIMES
USA SATURDAY NOVEMBER 11/SUNDAY NOVEMBER 12 2006

China forces dollar into the spotlight

By Peter Garnham

[illegible]

[illegible] reserves, the world's largest, had exceeded $1,000bn for the first time.

Analysts said while that was widely expected, it might spark a debate about the renminbi, which many of China's trading partners believed was undervalued.

However, it was the dollar that was thrust into the spotlight as Fan Gang, director of China's National Economic Research Institute and member of China's monetary policy committee, went on the offensive.

Mr Fan said the real problem the world faced was an overvalued dollar, not only against the renminbi but against all leading currencies. "The main responsibility for this imbalance lies with the US Treasury, which [illegible]," he said.

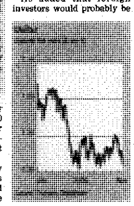
[illegible]

[illegible] fell 1.1 per cent to $1.2860 against the euro, fell 0.7 per cent to $1.9140 against sterling and dropped 0.4 per cent to Y117.50 against the yen.

Marc Chandler, currency strategist at Brown Brothers Harriman in New York, said Mr Zhou's remarks were nothing new and that dollar bears had merely used them as an excuse to sell the greenback.

"The real source of pressure on the dollar at present is not China's $1,000bn of reserves, but the US's $80bn, which is roughly the value of the US Treasury bonds maturing and coupon payments due on November 15," said Mr Chandler.

He added that foreign investors would probably be receiving about 40 per cent of those payments.



Mr Chaudler said that the continuing reduction of the US interest rate premium over the eurozone might encourage leakage of the payments away from simply being recycled into US Treasuries and put more pressure on the dollar.

The euro had a strong week, rising to a record high against the yen and climbing to a one-month peak against sterling amid increasingly hawkish rhetoric from the European Central Bank.

Writing in the Financial Times, Jean-Claude Trichet, president of the ECB, advocated the use of money supply data as well as price data in interest rate decision making.

Analysts said that stressing its role at a time when eurozone money supply was growing at a rate close to its fastest since 1999 pointed to a willingness on Mr Trichet's part to tighten eurozone monetary policy further after the 25 basis point rise widely expected next month.

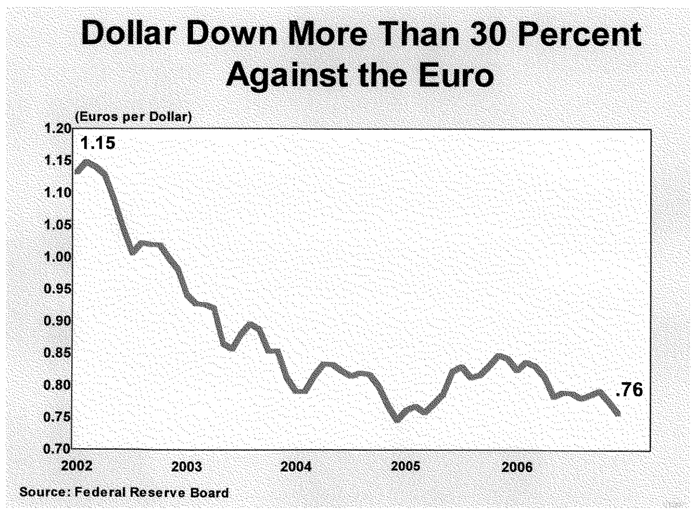
The euro rose 0.6 per cent to £0.6720 against sterling and 0.7 per cent to Y151.08 against the yen.

The euro's rise against sterling was exacerbated as the Bank of England struck a neutral tone on the future path of UK interest rates after raising them to 5 per cent after its monthly policy meeting.

The euro's climb against the yen set off alarm bells in Tokyo. Toshihiko Fukui, governor of the Bank of Japan, voiced concern about the effects on the yen of a sharp unwinding of carry trades, where investors borrow in currencies with low interest rates to invest in high-yielding assets.

Mansoor Mohi-uddin, chief foreign exchange strategist at UBS, said Mr Fukui's remarks were the most explicit to date on the subject and showed that Japanese policymakers had become worried about the size of short yen positions in the market.

I hope very much that colleagues are paying attention. In fact, the dollar's value is already down considerably, more than 30 percent against the euro, since 2002, at least in part from market fears about our increasing Federal indebtedness. We simply have to get hold of this trajectory on deficit and debt. There really is no alternative.



We have now been warned in this committee by the head of the Government Accountability Office. We have been warned by the head of the Federal Reserve. We have been warned by the head of the Congressional Budget Office. We have been warned just yesterday by the former head of the Congressional Budget Office and by three other distinguished panelists, including the Concord Coalition which is known for their interest in fiscal responsibility. Warned by the Heritage Foundation, one of their top economists, that we are on a course that is unsustainable. Warned by the head of the Hamilton Project, which is overseen, of course, by former Secretary of the Treasury Bob Rubin.

We have been warned and warned and warned. The question is, is there a will to act?

I would submit the first thing we have to do is submit a budget that is balanced by 2012, and at the same time engage in a much larger effort, a bipartisan effort, to produce a proposal to address these long-term fiscal imbalances. That is where the real danger lies.

With that I want to call on the witnesses, and I again welcome you to the committee. I would ask you to proceed with your testimony. Dr. Bergsten, why don't we begin with you.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMIC

Mr. BERGSTEN. Mr. Chairman, you are about to get another strong warning.

I am delighted to appear before the committee again. I agree with virtually everything you have said in your opening remarks. I deeply applaud and admire your efforts to forge an action plan to deal with the budget problem. I want to suggest in my testimony today that the international dimension of the issue may, in fact, most likely trigger a crisis that would force action in the absence of the kind of constructive and preemptive steps you want to take.

I start with my punch line, which is that the huge and growing international trade and current account imbalances, which of course center on the U.S. external deficits and debtor position that you have described, represent the single greatest threat to the continued prosperity and stability of both the U.S. and world economies. They could, at virtually any time, trigger a large and disorderly decline in the exchange rate of the dollar, which would initiate sharp increases in U.S. inflation and interest rates, bringing on at a minimum stagflation like we saw in the 1970's but quite possibly a deep recession.

Even in the absence of such a crisis—and that is a critical point—continued failure to address the imbalances constructively and preemptively, which you are trying to do, will inevitably lead to a costly and perhaps wrenching adjustment of the U.S. and world economies anyway. They could also lead to a disruption of U.S. trade policy, which is very hard to conduct in a sensible way with these huge international debts and deficits. That would threaten the openness of the global trading system. This is not our main topic today but is an element of this.

The only effective U.S. policy response to the problem, and I will describe that in a minute, is a conversion of present U.S., and as you said, particularly prospective U.S. budget deficits into modest surpluses, as the United States had in 1998 to 2001. You just suggested a goal of eliminating the deficit. I suggest that the U.S. should aim for modest surpluses.

The United States should in fact be running modest surpluses right now, because with the economy so strong in the last few years this would have been the ideal time to run a surplus. The strength of the economy has improved the budget and, as you mentioned, lulled some people to sleep about the need to deal with the underlying structural elements in it.

But actually at a time like this, the United States should take no comfort even from a modest deficit. It should be running surpluses of 1 or 2 percent of GDP in light of the strength of the economy. That is what then positions us for the inevitable slowdown, as well as the structural deterioration in the fundamentals that you have talked about. So anybody who is complacent today is really barking up the wrong tree.

The end of my punch line is that the possibility of a sharp dollar fall is, in fact, the greatest short-term risk that emanates from the budget deficits and provides the most compelling reason for urgent action on them.

Let me quickly tick off a few facts. The U.S. merchandise trade and current account deficits exceeded $850 billion last year and exceeded $900 billion in a couple of quarters at an annual rate, including the last one for which we have full data. It is now almost 7 percent of the economy, which is more than double the modern record the United States had back in the 1980's, after which the dollar dropped by 50 percent over 3 years against the other major currencies.

The U.S. external deficit has risen by an annual average of $100 billion for the past 4 years and almost that much for the last 10 years. In short, it is on a trajectory very much like the one you showed on the budget deficit. In fact, the two are quite parallel. That trajectory as well as the levels of the imbalances are, in my view, totally unsustainable.

At these present levels, United States current account deficits and external debt pose what I would regard as unacceptable risk to the United States economy and United States foreign policy. A country that spends more than it earns has to finance its deficit, just like an individual who spends more than he or she earns. So the United States has to attract foreign capital inflows of about $4 billion every working day to finance the current account deficit. In addition, U.S. companies and individuals make a lot of foreign investments and the United States has to offset those by capital inflows. The bottom line is that the United States has to attract about $8 billion of foreign capital every working day to keep its domestic economy afloat.

The stunning fact is that a trigger for a crisis would not necessarily be a drawdown of existing foreign dollar holdings, though that would make it much worse. All that is needed to trigger a big problem is a reduction in the inflow from the current $8 billion to say $4 billion or $5 billion. That would still be a lot of foreign investment in the United States It is not as if the world has to give up on the United States totally. But if the amount of annual inflow drops from the current roughly $2 trillion to half that or less, still a huge amount of foreign investment, that would trigger a substantial deterioration of the situation, the dollar would go down, et cetera, as I will describe. So the situation is really very precarious.

As a result of all of these deficits, U.S. net foreign debt reached $2.7 trillion at the end of 2005. An even more important number than U.S. net foreign debt, which you showed in one of your charts, may be U.S. gross foreign debt. Foreign entities, mainly private but some official, now hold about $14 trillion of dollar denominated assets in the United States. Almost all of it could actually be disinvested at any point in time. That could lead to a very sharp and indeed precipitous fall in the dollar, which would represent a free fall and a crisis.

So even though we focus on the net debt of about $3 trillion, which is big enough, the fact is the United States could not mobilize our private foreign financial assets to deal with a crisis. And so we really have to look at the gross foreign debt, which is now $14 trillion or more.

The major risk that the imbalances pose would be an elimination or reversal, or even sharp decline, of the very large net capital inflows. A cutback in the foreign capital inflow would immediately lead to a decline, perhaps very large and rapid, of the dollar exchange rate. That would push up the price of imported goods and services and the domestic products that compete with them, particularly now when the economy is close to full employment and there is, not much slack to take account of that.

Interest rates would rise by as much as inflation and probably by much more as the Fed had to raise rates to try to limit the decline of the dollar and its inflationary effect. The equity and housing markets would inevitably fall as a result. The economy would slow and perhaps drop into recession.

The operational question is always how much and when? One cannot give precise quantitative answers to that. But I suggest several reasonably reliable relationships that one can keep in mind.

Every decline of 10 percent in the average exchange rate of the dollar tends to increase United States inflation by about 1 percent, especially when the economy is at full employment like now and there is no slack to absorb that effect.

According to our calculations, and Bill Cline will elaborate on this, the dollar is still overvalued by at least 20 percent, maybe more. And that is calculated with a goal of simply cutting the U.S. current account deficit in half from where it is now. To eliminate the current account deficit and the buildup of foreign debt, it would have to do twice as much. We calculate that if the United States cut the current account deficit to say 3 percent of GDP—

Chairman CONRAD. Can I stop you on this point, because I really want this point not to be lost. Would you just repeat what you said with respect to what the dollar would have to decline in value in order to potentially address what we face here?

Mr. BERGSTEN. Yes. The first part of that should be the goal of the adjustment process. You have set a goal of eliminating the budget deficit. I say it ought to be a small surplus. On the external side—

Chairman CONRAD. Actually, we produce—under the budget I will propose, we do produce a small surplus.

Mr. BERGSTEN. That would be better yet.

Our analysis, which we have looked at very carefully, half a dozen of different senior fellows at our institute, what current account position would tend to be sustainable over time?

We do not believe the United States has to totally eliminate the current account deficit. We believe cutting it to about 3 percent of GDP, which is more than half from where it is now, would be sufficient. The reason for that, and Bill has analyzed this in great depth in his latest book called the United States as a Debtor Nation, is that if United States could level off the current account deficit at 3 percent, then the ratio of U.S. foreign debt to U.S. GDP would stabilize.

Chairman CONRAD. Stop growing.

Mr. BERGSTEN. It would stabilize at a riskily high level, around 50 percent of GDP.

Chairman CONRAD. Isn't that a key here—

Mr. BERGSTEN. Absolutely.

Chairman CONRAD [continuing]. Is that we stop—

Mr. BERGSTEN. Stop the buildup of the debt/GDP ratio.

Chairman CONRAD. This is one of the goals that I am emphasizing to my colleagues, is we have to turn these trend lines. Right now the debt is just up, up and away, both in real and nominal terms, as a share of GDP. And what we have to do is stop that growth. You would agree with that as a—

Mr. BERGSTEN. Yes, and bringing the external dimension into play. We have looked at the history of similar positions for the United States and other countries and tried to make some judgments based on the historical record of what is a relatively safe position. What does look like being sustainable if you could achieve it?

Chairman CONRAD. And what would that target be? Could you give that to us in GDP terms?

Mr. BERGSTEN. Yes. The ratio of United States net foreign debt to GDP that we think would be barely sustainable over time is about 50 percent.

Chairman CONRAD. Foreign debt to GDP.

Mr. BERGSTEN. The number is now about 20 to 25 percent. Given the current trajectory, there is no way you could level it off before you got to 50 percent. But if we took effective action now to start bringing the current account deficit down over the next 5 years, as you phase in your budget correction, the dollar could come down in a gradual and orderly way. Over a 5-year period, we believe the external deficit would come down from the current 7 percent of GDP to about 3 percent.

Chairman CONRAD. Which you think is sustainable.

Mr. BERGSTEN. If you maintained fiscal rectitude and the exchange rate did not soar and get overvalued again, then you could level off at that ratio. We think that would be sustainable.

Again, that is risky, 50 percent is high by historical standards. But given all of the history and our analysis, it is our judgment that that probably would be OK.

If you took a more conservative view and said you had to get the ratio down further or had to eliminate the current account deficit, then of course you would need much bigger adjustment both on the domestic side and in terms of the exchange rate.

Chairman CONRAD. You said earlier, and Senator Gregg is with us now, you said something that I think is very important. You indicated you believe the dollar is somewhere in the range of 20 percent overvalued. Is that correct? Did I hear you correctly?

Mr. BERGSTEN. Yes. Again, overvalued in terms of producing the kind of current account level and therefore—

Chairman CONRAD. A sustainable current account level.

Mr. BERGSTEN. That is right.

Chairman CONRAD. Let me just say, other top economists and policymakers have given me that same number.

Then you went further and you said—you referenced a 40 percent change in the dollar. I took it to mean that that would be what would be necessary to—I do not know if that would eliminate the trade imbalance.

Mr. BERGSTEN. That number would tend to eliminate the full current account deficit if you took the view that any further buildup of our foreign debt was too risky and you therefore wanted to totally eliminate the current account deficit. You would have to roughly double all of the numbers that I have been using because, instead of cutting the deficit, in half you would be going all the way to zero.

Chairman CONRAD. Let me just say, that is precisely what other top economists and policymakers have told me, those two numbers, 20 percent and 40 percent. If that does not get our colleagues' attention I do not know—you begin to wonder what will.

Mr. BERGSTEN. You would hope. A crucial variable, and I talk about it in my statement but we can handle it any way you want, is the following: as part of this adjustment, which I believe is inevitable, that the markets will force it on is at sometime if we do not preempt and do it in a constructive and orderly way ourselves.

As part of the adjustment, the dollar is going to have to come down by 20 to 40 percent. The real issue is whether it comes down in a gradual and orderly way, as in fact it has been doing over the last 5 years. Whether at some point confidence in our fiscal and other policies collapses and you get a free fall, which we have had historically—it in the late 1970's and mid-1980's—it is not a theoretical proposition. We know empirically that it can happen and we have actually had big declines of the dollar about once per decade over the last 40 years.

Chairman CONRAD. And so what? So what if we had a decline in the dollar?

Mr. BERGSTEN. Then you get three very clear effects. One is inflationary pressure, particularly if it occurs when the economy is close to full employment and full capacity utilization like the United States is now. You have no slack in the economy. The decline in the dollar is going to push up prices of imported products in the first instance, but through them the domestic products that imports compete with. So inflation goes up. I give some numbers in my statement. If the dollar declined even 20 percent, you would expect an increase of 2 percentage points or more in inflation. That would roughly double the current inflation level. That is step one.

Step two is that interest rates go up. Nominal interest rates, of course, go up with inflation. So that is a minimum effect. But if the Federal Reserve fears that the markets are going to keep pushing the dollar down more, and therefore generating even more inflation, then the Federal Reserve has to try to preempt that with higher interest rates. And so interest rates could go up from the current level of 5 percent, both short and long rates, at least to 7 or 8 percent. We have run models where interest rates go into double digits, at least for temporary periods, as a result of this kind of correction.

Again, it underlines the importance, Mr. Chairman and Senator Gregg, of your budget action. If you take the view, as I do, that these adjustments in the international position of the United States are inevitable, unless all economic history were repealed, they are going to happen. The question is how they happen.

Do they happen in an orderly and constructive way like preemptive action on the budget? Or do we just sit back and let it hit us? In which case the big effect could be a skyrocketing of inflation and interest rates. That chokes off private investment, which we need for long-term growth, and even cuts into consumer demand. A correction of the Federal budget position, which the United States needs for lots of other reasons anyway, even excluding the international side, is by far the more constructive way to do it.

If you start with my premise that adjustment is inevitable, you have a choice between the constructive preemptive approach and the "simply sit back and let it clobber you" approach.

In the constructive approach, you work the budget deficit down over a 5-year period, aim for a gradual but steady decline in the external deficit and the exchange rate of the dollar, which probably can be maneuvered in kind of soft landing terms.

If, by contrast, you do nothing, and let the budget deficit soar, which incidentally itself might trigger a free fall of the dollar because markets lose confidence, then the adjustment takes place through a skyrocketing of interest rates, maybe to double digits. So instead of tightening the fiscal side, you put it all on the financial markets and the Federal Reserve, interest rates soar, housing tanks, investment tanks, the stock market is tanked, and you wind up with an incredibly worse outcome.

Some people think the deluge can be avoided forever. You said it on the budget. Some people take that line on the international side, and they point to the fact, admittedly, that I and others have been expressing this concern for some time. So have you, Mr. Chairman. And they say the rest of the world is financing us and the rest of the world will be happy to keep financing us.

My point is that it is now up to $8 billion a day. We have $14 trillion of dollar holdings around the world, which at any point could be cut into, and it would be the most reckless stance of national policy to just assume that this can go on forever at such levels without triggering a deluge that would be disastrous for the economy.

And so you have to conclude that, it is not a matter of if, but when. I would add, when and how through constructive preemptive steps or through just letting it hit you and then almost certainly it would be higher inflation and higher interest rates.

I speak about this with some feeling, Mr. Chairman. I was running the international part of the Treasury Department in the late 1970's when we had the closest thing to a hard landing. There were a lot of other things involved like oil shocks. It was not just the dollar.

But the dollar plummeted. The United States needed a $30 billion rescue package for the dollar and drew on the IMF. The Federal Reserve had to raise interest rates one full percentage point, the first time in its history. And the United States had to cut the budget deficit substantially.

External uses have forced U.S. fiscal policy to change three times in the last period. In the late 1960's, President Johnson finally got his Vietnam War tax surcharge because of a succession of sterling and gold crises, which brought huge pressure to bear on the dollar. Secretary of Treasury Joe Fowler at the time said that Wilbur Mills and the Ways and Means Committee and Congress were finally convinced to finance the Vietnam War only because of the external crises.

It happened again when I was in the Treasury in the late 1970's. There had been a big debate within the Carter Administration. We in the Treasury had been arguing for fiscal restraint right from the start. But when the dollar collapsed in 1979, it was clear it had to be done and Congress went along.

To indicate the horrors that can result—people forget now because it is quite a long time ago—in the late 1970's, the United States had three consecutive years of double-digit inflation, interest rates above 20 percent, and the deepest recession in the second half of the 20th century. A big part of that was a collapse of the dollar.

And then, just to show that it is bipartisan, in the mid-1980's, when the dollar had become hugely overvalued, Jim Baker worked out the Plaza Agreement to negotiate a big decline in the dollar, between 30 and 50 percent depending on how you calculate it. To get that decline, and then to stabilize the dollar at the lower level, the United States had to accept the demands of the rest of the world to take some fiscal action to begin putting its own house in order. In 1986 and 1987 there was, temporarily it turned out, a substantial reduction in the budget deficit.

The point is that even fiscal policy itself can be forced into an unhappy and precipitous adjustment if you do not take preemptive action in not taken.

Chairman CONRAD. Let me just stop you, if I can, on that point and say that is the message. I hope colleagues are listening.

[The prepared statement of Mr. Bergsten follows:]

THE CURRENT ACCOUNT DEFICIT
and
THE US ECONOMY

A Hearing Before the
Budget Committee of the
United States Senate

C. Fred Bergsten
Director, Peterson Institute for International Economics

February 1, 2007

The Problem

The huge and growing international trade and current account imbalances, centered on the US external deficits and net debtor position, represent the single greatest threat to the continued prosperity and stability of the United States and world economies. They could at any time trigger a large and rapid decline in the exchange rate of the dollar that would initiate sharp increases in US inflation and interest rates, bringing on stagflation at a minimum and quite possibly a deep recession.

Even in the absence of such a crisis, continued failure to address the imbalances constructively will inevitably lead to a costly and perhaps wrenching adjustment of the US and world

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Dr. Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He was previously Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). The latest of his 37 books is as co-author of *China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower*, prepared jointly by the Center for Strategic and International Studies and the Institute for International Economics and published by Public Affairs Press in March 2006.

economies. They could also lead to a disruption of US trade policy, threatening the openness of the global trading system.

The only effective US policy response to the problem, as its critical contribution to the needed global solution[1], is a conversion of our present (and especially prospective) budget deficits into modest surpluses à la 1998-2001. The possibility of a sharp dollar fall is in fact the greatest short-term risk now emanating from our budget deficits and provides the most compelling reason for urgent action on them. I am very pleased that the Senate Budget Committee today, and the House Budget Committee last week, are addressing these international dimensions of our fiscal position and urge you to take forceful action to correct both our internal and external deficits before it is too late.

The Current Situation

The US current account deficit reached $850-875 billion in 2006. It has exceeded annual rates of $900 billion in a couple of recent quarters, including the latest for which full data are available (the third quarter of 2006). It now accounts for about 7 percent of GDP, more than double the previous modern record of 3.4 percent in the middle 1980s (as a result of which the dollar dropped by 50 percent against the other major currencies over the three-year period 1985-87).

[1] China is the largest surplus country and also has a crucial role to play in the adjustment process. See my testimony on that topic of January 31, 2007 to the Senate Committee on Banking, Housing, and Urban Affairs.

Our external deficit has risen by an average of $100 billion annually over the past four years. It has climbed by an annual average of $80 billion for the past nine years. The trajectory as well as the level of the imbalances is clearly unsustainable.

There are a few signs that the sharp and steady rise of the US current account deficit may be leveling off. Excluding the impact of much higher prices for oil imports over the past year, the aggregate deficit is largely unchanged. Our trade imbalance with Europe has declined modestly, due to a pickup in European growth and the lagged effects of the substantial decline of the dollar against the euro in 2002-04. Our exports have risen about twice as fast as our imports over the past couple of months for the first time since the late 1980s, after the sharp dollar fall of the previous three years. (That currency adjustment, combined with the recession of 1990-91, virtually eliminated our external deficits in the early 1990s.)

The Risks to the US Economy

Even at their present levels, however, our current account deficits and external debt pose unacceptable risks to the US economy and to US foreign policy. A country that spends more than it earns has to finance its deficit just like an individual who spends more than she or he earns. Hence the United States must attract capital inflows of almost $4 billion from the rest of the world every working day to finance our current account imbalance. In addition, the United States makes large investments around the world that average between $500 billion and $1 trillion per year. These too must be offset by capital inflows so our total international funding requirement is on the order of $8 billion every working day.

As a result of these pervasive deficits, the United States has compiled a net foreign debt that reached $2.7 trillion at the end of 2005 (the latest date for which full data are available). An even more important number is our gross foreign debt of almost $14 billion because this measures the huge stock of dollar assets held around the world, most of which could be converted into other currencies or assets at almost any time.

Our payments to foreigners on our net foreign debt are surprisingly small and have in fact just recently turned negative. This is because US investors, especially direct investors, earn much more on their holdings abroad than foreigners earn on their holdings in the United States. This "net investment income" item will continue to deteriorate steadily in the future, however, adding further to the annual current account deficits and generating a lasting reduction in American incomes as we transfer a rising share of them to the rest of the world.

The major risk that the external deficits and debt pose for the United States, however, stems from the potential sharp reduction, or even elimination or reversal, of the very large net capital inflows that are required to finance them. Such a cutback would immediately lead to a decline, perhaps very large and very rapid, of the exchange rate of the dollar. This would in turn push up the prices of imported goods and services, and of the domestic products that compete with them. Interest rates would rise by at least as much as inflation, and probably by much more as the Federal Reserve tried to check the further inflationary pressures that would result from additional depreciation of the dollar. The equity and housing markets would inevitably fall, perhaps sharply, in response. The economy would slow and perhaps drop into recession.

It is impossible to quantify, with any precision, either the magnitude or timing of these events. We do know, however, that a very substantial correction of the US external deficit, including via a very large decline of the exchange rate of the dollar, is inevitable unless all economic history is repealed. Several reasonably reliable relationships can be invoked to suggest the possible course of events:

- every decline of 10 percent in the trade-weighted average of the dollar tends to increase US inflation by about 1 percentage point, especially if it occurs when the economy is operating near full employment as at present;
- the dollar is currently overvalued by at least 20 percent, and perhaps considerably more, even if the adjustment goal were "simply" to cut the current account deficit in half from its present levels (on the view that a deficit of 3-3½ per cent would eventually level off the rate of net foreign debt to GDP and thus be sustainable);
- hence the inevitable dollar decline, especially if it were to occur precipitously, could double the present inflation rate of 2-3 percent to at least 4-6 percent;
- this would in turn push interest rates up from their current level of about 5 percent to 7-8 percent, and plausibly under some scenarios even into double digits for a period of time, tilting an economy that is already softening considerably in the direction of outright recession.[2]

My own judgment is that the US economy is more likely to experience a soft landing rather than a hard landing from the present imbalances. The fundamentals of the US economy remain strong

[2] Martin Neil Baily, "Persistent Dollar Swings and the US Economy," in C. Fred Bergsten and John Williamson, eds., *Dollar Overvaluation and the World Economy,* Washington, Institute for International Economics, February 2003.

and there is no incentive for capital flight out of the dollar. The economies of Europe and Japan, while recovering to some extent from their recent prolonged stagnations, do not offer sufficiently attractive investment opportunities to prompt huge shifts from the United States. There is very little, if any, risk that foreign central banks or other official entities would sell dollars abruptly for political reasons; doing so would sharply reduce the volume of their (large) remaining dollar holdings and, even more importantly, any such actions would run directly counter to their overriding missions of fostering economic and financial stability in both their own countries and internationally. If the dollar were to start plunging, the G-7 and other relevant countries (e.g., China and some other Asians) would in fact surely agree to joint intervention in the currency markets to buy dollars and hence limit the damage to all their economies.

On the other hand, a number of factors point in the opposite direction and toward the risk of a more brutal correction. As noted, the US deficit is twice as large as its previous record – after which the dollar declined, over three years, by more than 30 percent on average and by more than 50 percent against the other major currencies (DM and yen). The present imbalance has been building up for more than a decade, compared with the five-year runup to the previous peak. The US economy is now at, or very near, full employment so a fall in the dollar would pass through more fully and more quickly into inflation and interest rates. (The substantial dollar decline in 2002-03 did not have such effects because we were just recovering from the recession of 2001 and there was still considerable slack in the economy.) The economy is now softening, probably to growth of less than 3 percent for 2007, so a severe external shock could push it into recession.

Potentially even more important are two key structural factors. First, the United States is piling its present external deficits onto the world's largest debtor position. Our imbalances of the 1980s began when the United States was still the world's largest creditor country and, in some sense, "used up" the net asset position accumulated over the previous half century or more. We have no such cushion today.

Second, the creation of the euro provides a true international financial alternative to the dollar for the first time in a century. The dollar has dominated global finance since the decline of sterling in the early twentieth century largely because it had no real competition. No other currency was based on an economy or capital markets anywhere near the size of those of the United States. The creation of the euro eliminates the dollar's currency monopoly, however, because the economy of Euroland is almost as large as that of the United States while its international trade and monetary reserves are even larger. Indeed, euro bonds have attracted more international investment than dollar bonds for the past two years and global holdings of euro currency now exceed those of the dollar. Hence the euro presents, for the first time in modern history, a true alternative to the dollar for footloose international investment that might previously have moved into dollar assets or that might already be invested in dollars.[3]

It is essential to recognize that the US economy will experience significant adjustment effects when the imbalances correct whether the "landing" is hard or soft. As our current account deficit declines, hopefully by at least 3-4 percent of GDP, a similarly increased proportion of domestic output will be sold to foreigners rather than consumed by Americans. Thus domestic US

[3] See C. Fred Bergsten, "The Euro and the Dollar: Toward a 'Finance G-2'?" in Adam S. Posen, editor, *The Euro at Five: Ready for a Global Role?* Washington, Institute for International Economics, April 2005, especially pp. 30-35.

demand will have to rise more slowly, eventually declining as a share of GDP by 3-4 percent. It would be undesirable to limit private investment as a part of this process since doing so would undermine the long-term growth potential of the economy. Cutbacks in private consumption, which would permit an increase in private saving, would help but cannot be counted on since there are no policy tools that are reliably effective in promoting such a shift.

The Policy Implications

Hence the central policy response to the unsustainable international economic position of the United States must be conversion of the budget position of the Federal government, over the next few years, from today's deficits of 2-3 percent of GDP to modest surpluses à la 1998-2001. Such a shift would both reduce domestic demand by the needed 3-4 percent of GDP and cut our requirement for foreign financing by a like amount.

Renewed growth of the budget deficit, by contrast, could trigger a hard landing. Under present circumstances, larger budget deficits would almost certainly lead to larger external deficits (as they did in the 1980s). Even more importantly, the implied lack of financial discipline in the United States might be the proverbial "straw that broke the camel's back" of confidence in the dollar and prompted foreign investors (and perhaps many Americans too) to move into other currencies.

Fiscal consolidation has been forced on the United States by external events on at least three occasions in the postwar period. In the late 1960s, the escalating gold and sterling crises finally convinced Congress to pass President Lyndon Johnson's import tax surcharge to help finance the Vietnam War. In the late 1970s, the Carter Administration and the Congress had to tighten budget policy sharply when we experienced the hardest landing to date of the dollar and the US economy – to double digit inflation for three years, interest rates that rose about 20 percent and the deepest recession of the second half of the 20th century. In the late 1980s, the G-7 countries would agree to stabilize the dollar after its sharp three-year fall only when the United States agreed to start reining in the large budget imbalances of that decade. It would be far superior on this occasion to take preemptive action that, in light of the magnitude and duration of our external deficits and debts, could be far more damaging than any of these previous episodes.

It must be noted that there is no automatic link between the US budget and current account deficits. The external imbalance in fact soared anew during the late 1990s while the budget was moving into surplus (because domestic investment was running at postwar highs and continuing declines in private saving offset much of the reduction in public dissaving). In theory, there could be some offset to increases in public saving achieved by budget improvement via reduced private saving (though the two have tended to move in similar rather than opposite directions in the United States in recent decades).

The deficits were much more closely related throughout most of the 1980s, however, when both reached their previous record highs and required substantial adjustment. The external deficits would probably be much larger today had the budget not improved so dramatically during the 1990s. The tax cuts and large spending increases of the early years of this decade clearly worsened our external position, by further reducing national saving, and played central roles in pushing it to today's precarious levels. Indeed, less expansionary fiscal policy in recent years would have reduced the need for tightening of monetary policy by the Federal Reserve and produced a weaker dollar that would have strengthened our current account. Budget correction would almost surely promote external adjustment under current circumstances, perhaps by around one half of the improvement in the budget itself.[4]

Trade policy is not the topic of this hearing but I would note, before closing, that the creation of new US barriers to imports of goods or capital would be a wholly inappropriate response to our trade and current account deficits. It is historically true that large US external deficits and the dollar overvaluations that help spawn them have been the best predictors of resistance to open trade policies, because they shift the politics of US trade policy in a restrictive direction. As indicated throughout my statement, however, these large imbalances are a macroeconomic problem that require macroeconomic (including exchange rate) remedies and for which new trade barriers would be ineffectual. It would be particularly counterproductive to discourage inflows of direct investment or any other forms of foreign capital, which we must continue to attract as long as we run (even a reduced level of) current account deficits, as might well be the result of some of the current proposals for "reforming" the Committee on Foreign Investment in the United States (CFIUS) and US policy in that area more broadly.[5]

There are strong reasons to convert the current, and especially prospective, US budget deficits into modest surpluses without appealing to these international aspects of the issue. But the

[4] There is a wide range of estimates of this relationship but they tend to cluster around 50 percent. The main outlier is the Federal Reserve, whose much lower estimates are explained and criticized in William R. Cline, *The United States as a Debtor Nation*, Washington; Institute for International Economics, September 2005.
[5] Edward M. Graham and David M. Marchick, *US National Security and Foreign Direct Investment*, Washington, Institute for International Economics, May 2006.

vulnerability of the US economy to large and prolonged reductions in foreign capital inflows, especially if such shifts were to occur abruptly, surely counsel that we "put our house in order" as promptly as possible. I am delighted that the Committee is assessing these issues as part of its deliberations on the fiscal situation and hope my analysis will help persuade you to adopt an aggressive stance to sharply improve its prospects over the coming budget cycle.

Chairman CONRAD. Let me go to Dr. Cline, and then we will go to Malpass and then open to colleagues for questions.

Dr. CLINE.

STATEMENT OF WILLIAM CLINE, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. CLINE. Thank you very much, Mr. Chairman.

It is an honor for me to testify before this committee. I, too, strongly agree with your introductory remarks.

The United States has gone from being the world's largest creditor nation to its largest debtor nation. In 1971 to 1975 the average net foreign assets were 11 percent of United States GDP. At the end of 2005, we had net foreign liabilities of more than 20 percent of GDP. The cumulative large current account deficits, of course, were the proximate cause. Last year our current account deficit reached almost 7 percent of GDP or about twice the previous peak in 1987.

The deficit was up from 1.7 percent of GDP in 1997. This was closely driven or heavily driven by the 28 percent real appreciation of the dollar from 1995 to 2002. That, of course, made United States exporters less competitive and made imports more attractive.

There has been some dollar correction. The dollar has come down 13 percent from 2002 to 2006 on a real trade-weighted basis. But I believe, as my colleague Fred Bergsten has said, that there is a long ways to go.

The adverse trend in United States debt has occurred—external debt—despite two very strong unique advantages. The first advantage is that the United States has a higher return on its direct investment abroad than foreign holders of direct investment in the United States get. That difference is about 4.5 percent.

The second unique advantage is that unlike Argentina, who owed its debt in foreign currency, we owe our debt to the rest of the world in our own currency. We have assets abroad in foreign currency. So every time the dollar goes down, we have a windfall gain in the valuation of our net position.

Despite these advantages, we have had this adverse trend.

Fred has outlined the near-term hazards of the situation. I would like to focus on the longer-term burden, as well as the link to fiscal policy.

On the long-term burden. Even if the current account were to stabilize at 7 percent of GDP, then after about 20 years the net foreign debt would be about 100 percent of GDP. But we cannot actually expect it to be that favorable under current trends. With the dollar in real terms where it is now, the baseline that I calculate is that the current account deficit will reach 14 percent of GDP at the end of two decades and net foreign liabilities would reach 140 percent of GDP.

One of the main drivers of this is the fact that we are now decisively swinging into negative balances on our capital earnings despite the difference in the rate of return. Why? Because we have more foreign debt.

And then second, imports are about 50 percent larger than exports, so an equal percentage growth on both sides just keeps widening that gap.

Now the danger, it seems to me, is that there is a threshold beyond which United States foreign debt should not be allowed to rise. For developing countries, the critical debt crisis threshold is about 40 percent of GDP. The United States economy is obviously stronger than developing countries, but the United States has a lot of international obligations, a lot of impact on the international economy. I do not think it is prudent for the United States to build-up net foreign debt that exceeds 50 percent of GDP. This is the same threshold that a number of other experts who have analyzed this question tend to arrive at.

So we are not on a sustainable path. The choice is basically between an earlier smoother adjustment and a later painful adjustment.

In my model simulations, if we try to stay within a 50 percent ceiling for net foreign debt by the end of 20 years, if we have early adjustment, cutting the current account deficit to 3 percent over 3 years, then you have a much smoother phasing in of the belt tightening.

If instead we wait for 10 years, then the gap will be so large that you would have to cut consumption and investment by something like 13 percent from the baseline in order to get within a path that would get you back to that ceiling of 50 percent.

We need the exchange rate to move to do that. It is critical to get China and other Asian economies to stop intervening in the currency markets and piling up mountains of reserves in order for that to occur.

It also looks increasingly likely that we will need to have a coordinated intervention to reverse the inappropriate recent decline of the yen. After all, there was intervention to reverse the decline of the euro some years ago. We will have to make the exchange rate adjustment.

But let me turn to the fiscal adjustment. Fiscal policy is relevant because by national accounts identities, our trade deficit is the result of our excess use of resources above our resources available at home. Now that also means it is the excess of investment over saving. And Government dissaving is eroding our national saving.

The fact is that from the average of 1997 to 2000 the fiscal accounts deteriorated by about 4 percent of GDP. The current account deteriorated by about 3 percent of GDP. So we can see the handwriting on the wall, that this contraction in the domestic saving that is caused by Government dissaving is a major factor. Obviously there are other factors. Private household saving has declined with the stock market boom and then the housing boom, so that people did not feel they needed to save as much out of current income. But we cannot count on how soon that will reverse.

And if there is anything we have learned, is that the only way to affect saving is through affecting Government saving. We do not have policies that can affect private saving in any reliable way.

So the second component of an adjustment process has to be fiscal adjustment that complements the exchange rate adjustment. And that is especially important because of the long-term challenges of Medicare and Medicaid, in particular, and also Social Security.

So I agree, I think we need a swing in the fiscal accounts from about a 2 percent deficit, and if you look at the CBO projections, it is 2 percent if you make realistic assumptions about the discretionary spending, the alternative minimum tax, if you also extend the tax cuts. We need to squeeze that or reverse that to about a 1 percent surplus, which ironically is what the CBO baseline is doing. If we could actually reach the CBO baseline, we would be home free.

So with that, I would simply say there are many reasons that we need to get the fiscal adjustment in its own right, but I think a strong reason for doing so, in addition, is a need to get our external house in order.

Thank you.

[The prepared statement of Mr. Cline follows:]

THE FISCAL DEFICIT AND THE U.S. EXTERNAL DEFICIT

Statement by
William R. Cline, Senior Fellow
Peterson Institute for International Economics
and Center for Global Development[1]

before the Hearing on

The Current Account Deficit and U.S. Foreign Debt

Budget Committee
United States Senate
February 1, 2007

It is an honor and a pleasure to be invited to testify before this Committee. In my view, it is crucial for the United States to eliminate its fiscal deficit and to substantially reduce its external current account deficit. Because the fiscal deficit affects the current account deficit, I believe that the Committee is well advised to consider the external sector dimensions in its deliberations on U.S. fiscal policy. Let me begin with a brief review of how the current account and external debt have arrived at where they now stand. I will then examine the long-term burden of the growing U.S. foreign debt, and conclude with an analysis of how fiscal adjustment could contribute to external sector adjustment. I will base most of my comments on my recent book, *The United States as a Debtor Nation.*[2]

[1] Dr. Cline was formerly Deputy Managing Director and Chief Economist of the Institute of International Finance (1996-2001); Senior Fellow at the Institute for International Economics (1982-1996) and Brookings Institution (1973-81); and Deputy Director for Trade and Development Research at the U.S. Treasury Department (1971-73). He is the author of 21 books and numerous articles on trade, development, and international finance.
[2] Institute for International Economics and Center for Global Development, 2005a.

From Creditor to Debtor Nation Status

In the early 1970s, U.S. citizens, corporations, and the government owned much more in assets abroad than they owed in foreign liabilities. In 1971-75 net foreign assets averaged about 11 percent of GDP. Beginning in the 1980s, however, the United States persistently ran trade deficits as well as deficits in the overall current account -- which includes capital income and transfers. There have been two large deficit cycles, the first peaking in 1987 and the second one beginning in the mid-1990s and still showing no signs of reversal. As a consequence, the United States had dissipated its international creditor position by 1988; and by the end of 2005, U.S. external liabilities exceeded foreign assets by about 20 percent of GDP.

In the more recent cycle, the current account deficit has risen from 1.7 percent of GDP in 1997 to about 7 percent in 2006, or about twice the 3.4 percent of GDP peak in the 1980s cycle. In addition to rapid U.S. growth, the main factor driving the widening deficit has been the real appreciation of the trade-weighted value of the dollar by 28 percent from 1995 to 2002.[3] The dollar fell in real trade-weighted terms by 13 percent from 2002 to 2006, but it still has a considerable distance to decline before the exchange rate incentive will be in place to begin narrowing the deficit to more sustainable levels.

The swing from large creditor to large debtor has happened despite two unusual U.S. strengths: a high return on direct investment abroad (which is about 4.5 percent higher than the return on foreign direct investment in the United States); and the fact that U.S. debt obligations abroad are almost fully in dollars whereas U.S. equity and direct investment claims abroad are in foreign currency, so that there is a windfall valuation

[3] Using the Federal Reserve's broad real exchange rate index.

gain whenever the dollar declines. Without these two unusual features the swing into net debtor status would have been even greater.

Why the Current Account Deficit Matters: A Long-term View

In his testimony for this hearing, my colleague C. Fred Bergsten has stressed the near-term hazards associated with our present large external deficit. There could be a "hard landing" for the U.S. economy and perhaps the world economy if there were an unfavorable shift in confidence and a decline in the massive capital inflow needed to finance the U.S. current account deficit (and U.S. capital outflows). Higher interest rates and a severe decline in the stock market and consumption, along with a recession, could be the result. There could also be an outbreak in protectionism associated with an ever-widening trade deficit.

Let me complete the picture by focusing on the longer-term risks associated with continuing along our present path, in the event that foreign capital markets essentially give us enough rope to hang ourselves rather than cutting off capital supplies in the near future. It is important to recognize what last year's rate of 7 percent of GDP for the current account deficit would imply if it were maintained indefinitely. The long-term nominal growth rate of the economy is only about 6 percent (say, 3.5 percent real growth plus 2.5 percent inflation). So if the current account deficit stayed at 7 percent of GDP, net foreign liabilities would keep rising until they eventually exceeded one hundred percent of GDP. That is, the long-term ratio of net foreign debt to GDP stabilizes at the ratio of the current account deficit as a percent of GDP to the nominal growth rate of GDP, in this case about 1 to 1 at 6 percent for both.

A foreign debt ratio of 100 percent would be extremely risky. In Latin America and other developing regions, debt crises have tended to occur once external debt exceeds about 40 percent of GDP. Even though the US economy is much stronger than most developing economies, surely there is some limit to a safe foreign debt level for the United States. Given the global responsibilities of our economy, I would place that prudential limit at about 50 percent of GDP, even after taking account of higher return on foreign assets than on liabilities to foreigners. To keep below this ceiling, it will be necessary to reduce the current account deficit to about 3 percent of GDP (that is, half the nominal GDP growth rate).

Instead, what we are doing at present is building up an imbalance that will be increasingly costly for us and our children to correct in the future. My baseline projection shows the U.S. current account deficit pausing at a plateau of 7 percent of GDP but then rising steadily to about 14 percent of GDP after two decades. This ongoing deterioration occurs despite the unique advantages on rate of return and currency valuation of assets. It is driven by a large swing from surplus into deficit in capital income as net liabilities rise; and also by the simple fact that because imports exceed exports by about 50 percent, growth in the same proportion on both sides causes a widening gap. Over the two-decade horizon, net external liabilities would rise to 140 percent of GDP in this baseline, a wholly unsustainable level. The basic choice, then, is between an earlier, smoother adjustment and a later, more painful one.

In my model simulations of alternative paths to limit net foreign liabilities to 50 percent of GDP, an early reduction in the deficit to 3 percent of GDP over the next three years would spread the inevitable belt-tightening much more smoothly over time than would an adjustment delayed for a decade. Late adjustment would mean no cuts from baseline consumption and investment in the first decade but a cutback by about 13 percent from baseline in the second decade. In early adjustment, the cuts from baseline would be much more evenly phased, at about 4-1/2 percent in the first decade and 9 percent in the second. Essentially, in our external accounts we face the same issue of imposing an undue burden on the future that we face in our domestic fiscal accounts.

Correcting Dollar Overvaluation

In order to cut the U.S. external deficit in half, my model estimates suggest that the dollar will need to fall in real terms by an additional 15 to 20 percent on a trade-weighted basis, supplementing the partial correction that has already occurred from the dollar's high point in 2002. This further correction will need to be mainly against the currencies of China, Japan, and other major Asian economies (including Malaysia, Hong Kong, and Singapore). In contrast to the euro and most other industrial country currencies, the Asian currencies have not risen much at all against the dollar. I have suggested an "Asian Plaza Agreement" or a broader "Plaza II" to help bring about this correction.[4] Whatever the mechanism, for sufficient currency adjustment to occur it will be essential that China and other Asian nations stop intervening in the foreign exchange market and increasing their already massive reserves in an effort to prevent appreciation of their currencies. It also appears increasingly likely that there will be a need for coordinated intervention to reverse the decline of the yen, just as there was coordinated intervention to reverse the decline of the euro earlier this decade.

[4] See Cline, 2005a, chapter 6; and my essay "The Case for a New Plaza Agreement," *Policy Briefs in International Economics* No. PB05-4, Institute for International Economics, December 2005b.

Why Fiscal Adjustment is Important to External Adjustment

For the purposes of this hearing, however, I would like to focus on the other instrument of external adjustment: fiscal policy. Most international economists have long recognized that adjusting a current account deficit requires both a relative price effect from exchange rate realignment (sometimes called "expenditure switching") and a consumption-curbing effect from increased domestic saving (sometimes called "expenditure reduction"). A decline in the dollar makes imports more expensive and U.S. exports more competitive, but if there is no accompanying rise in the nation's aggregate saving, the result may be a strain on capacity and a rise in interest rates, resulting in a subsequent rebound in the dollar that frustrates the potential trade adjustment.

Fiscal policy is directly relevant because government saving is part of national saving. The national income accounts necessarily impose the following relationship: the trade deficit equals the excess of domestic resource use over domestic resource production. This turns out, again by an accounting identity, to show that the trade deficit equals the excess of domestic investment over domestic saving. Domestic saving in turn equals saving by corporations, households, and the government. When the government is dissaving, it is inherently placing pressure on domestic use of resources and hence exerting pressure tending to widen the trade deficit.

From 1997 to 2004, total U.S. saving fell by 4 percent of GDP (from 17.6 percent to 13.6 percent). This was the main force driving the widening of the current account deficit by a similar amount (from 1.6 percent of GDP to 5.7 percent). In turn, a driving force in the decline of national saving was the downswing in the U.S. fiscal balance by about 5 percent of GDP from 2000 to 2004, even after taking out cyclical influences. The U.S. fiscal erosion mainly reflected a decline in federal tax revenue, which fell from 20.9 percent of GDP in 2000 to 16.3 percent in 2004. The tax cuts of 2001 and 2003 were a key source of this decline, accounting for a reduction of tax revenue by 2.6 percent of GDP in 2004 from levels that otherwise would have been reached.[5]

Of course, private saving was also falling. From 1990 to 2005, personal saving fell from about 7-1/2 percent of disposable income to about 1-1/2 percent. The most likely explanation is that households felt richer because of, first, the stock market boom, and then (even more importantly for most households) the housing market boom. With windfall gains more than covering their target wealth accumulation, households saved less and less out of current income. Maybe that process will begin to reverse with the now stagnant housing market and more normal stock market conditions. But if there is anything we have learned about macro-economic policy, it is that we have no reliable policy tool to increase private saving. So if public policy is to have an effect on national saving and hence the external deficit, it must be through use of the instrument of fiscal policy to shrink the government's dissaving (i.e. the fiscal deficit).

That is why the second major component of a package for U.S. external adjustment, in addition to further correction in the dollar, is the elimination of the federal budget deficit, and ideally a move into small surplus. Despite the recent mainly cyclical gains in the fiscal outcome, the prospective deficit seems likely to remain in the range of 2 percent of GDP over the next 5-7 years if the tax cuts are extended, the alternative

[5] Cline, 2005a, pp. 111-112; 204-205. This U.S. fiscal "smoking gun" is why I am skeptical of the argument made by U.S. Federal Reserve Chairman Ben Bernanke that the current account deficit is simply a manifestation of a global saving glut caused by falling investment in Asia and Latin America after regional crises. My analysis shows that the appropriate contribution from that source was only 0.7 percent of GDP, a modest fraction of the deterioration in the current account.

minimum tax is reformed, and plausible assumptions are made about discretionary spending.[6] The fiscal outlook is of course even more challenging over a longer horizon because of rising social security and (especially) medicare-medicaid costs. A longer perspective would simply reinforce the need for early action.

It should be recognized that a 3 percent of GDP upswing in the fiscal outcome (e.g. from –2 percent of GDP to +1 percent) would not necessarily narrow the current account deficit by 3 percent of GDP, despite the national account identities. Those accounting relationships hold *after* taking account of induced effects. A smaller fiscal deficit would tend to reduce the interest rate, which in turn would tend to boost investment and consumption. As a consequence, the reduction in the excess of resources used domestically over resources available domestically would be less, after the induced effects, than the amount of the initial budget correction. Nevertheless, a reasonable relationship would be a reduction of about 50 cents in the current account deficit for each dollar reduction in the fiscal deficit, and if coupled with a strong independent correction of the exchange rate the relationship could be higher.

In sum, it is widely recognized that there are major domestic reasons for moving aggressively to eliminate the fiscal deficit. The case for doing so is even stronger after considering that fiscal adjustment will almost surely be a necessary part of external sector adjustment. In the absence of correction, the external imbalance is on a track that sooner or later will lead at best to an unpleasant second half of the journey, and at worst to a train wreck.

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[6] Projections by the Congressional Budget Office indicate that these three influences would respectively boost the deficit in 2012 by $296 billion, $35 billion, and $110 billion, placing the budget in deficit at 1.6 percent of GDP instead of a potential surplus of 1 percent of GDP. CBO, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*, January 2007.

Chairman CONRAD. Thank you very much for that important testimony.

Mr. Malpass, thank you very much for being here. We appreciate your taking your time to contribute to the work of the committee.

STATEMENT OF DAVID MALPASS, CHIEF GLOBAL ECONOMIST, BEAR STEARNS

Mr. MALPASS. Thank you, Mr. Chairman and Senator Gregg. It is a pleasure to be here. Thank you for the invitation.

I surmise that I am here, in part, to take a different point of view, which I will try to launch into here.

I listened with great interest to Fred's recounting of some of the historical hard times that we have had related to dollar weakness and inflation, and I think we probably all share an interest in not going back to that.

In recent years, the good news is that United States growth has been faster and steadier than most expectations. Even so, there is a frequent view that the United States is on the wrong economic path. And that is primarily where I want to take a different point of view.

People have been talking for several years now about us heading into a slowdown or a recession, in part due to the trade deficit. Instead, the United States has enjoyed a strong multiyear expansion. Growth in 2006 was faster than in 2005, despite the view that things were hard. And 2007 looks equally robust to me.

If that is the case, we will end up with having 5 years in a row with over 3 percent real growth, a very strong economic performance. Rather than the trade deficit slowing the economy or causing higher interest rates the rising trade deficit and the net foreign debt, have coincided with strong growth, profits, and job creation for the United States economy. Unemployment has fallen to 4.5 percent. The fourth quarter of 2006 saw a net 1 million new jobs created in the United States, again associated or coinciding with a large trade deficit.

I will go through some of the graphs in my written testimony. The unemployment rate has fallen steadily and that has been one of the sources of strength for the United States economy.

I am expecting some inflation problems because of the weaker dollar, and I agreed with Fred's concerns over dollar weakness generating inflation. In 2005, we already saw the United States economy get to 4.7 percent CPI inflation. So we have already had some experience with severe inflation in this expansion.

The fiscal situation is worth pointing out. The debt to GDP ratio is already falling at a relatively brisk clip. We are down to 37 percent of debt to GDP. The fiscal deficit has fallen to an expected 1.5 percent of GDP in fiscal 2007 and CBO projects a surplus in the near term.

Turning to the trade deficit, I will go through briefly some of my thoughts in this area. First and most importantly it is normal for the United States to run a trade deficit. With the exceptions of war time and recessions, the United States has usually been running a trade deficit. One exception was after World War II when the United States was helping rebuild Europe and Japan and there was a capital outflow. But for most of our economic history, it has run a trade deficit.

Countries with trade deficits often produce more growth and jobs than countries with trade surpluses. We have only to look at Japan, with its large trade surplus and difficulty creating jobs, the

European Union in that same condition running a trade surplus, having difficulty creating jobs, to see that point.

The trade deficit is large as a share of GDP right now, in part because the differentials that drive it are large. The differentials driving the trade deficit include the growth differential. Between 1992 and 2006, the United States grew 110 percent, whereas the rest of the world grew roughly 95 percent. So there was a big expansion of the United States relative to the rest of the world. This causes our imports to go up more than our exports. That is part of the trade deficit.

A second driver for the trade deficit is the demographic differential. There has widened out now an unprecedented gap between United States demographics and those of Europe and Japan in terms of aging. To dramatize it, think of Japan, where the under–60 population is expected to decline 3 to 4 percent every 5 years for the next generation. They have fewer and fewer people needing capital and they have an urgent need for capital abroad. Thus, a powerful driver for the trade deficit is the demographic differential. The United States alone among the major industrialized countries has a growing population of people under 60 that need capital and need goods. And that is going to go on for the next 50 years. It is not going to shift. And I am expecting the trade deficit to be with us for a long time.

The third strong factor creating this particularly wide trade deficit that we have now is the investment differential. The United States invested $842 billion more than national savings in 2005. In contrast, foreigners invested $670 billion less than their savings. So the lack of an attractive investment climate abroad urges foreigners to put their money into the United States, where they get a better return on investment. There is data in my statement showing the higher returns offered in the United States and the attractiveness to the United States for that foreign investment.

Now an important point in this is how can this be normal, to—as Fred put it—spend more than we produce? Actually, that is a very normal condition in economic theory and practice. Growth companies do that all the time. Most corporations are spending more than they produce. The difference is the increase in their debt. And if you stop that increase in debt, the company would not be able to grow. The United States is doing the normal thing, spending more than we produce, and funding the gap with capital in the same way that a corporation does with a bond offering.

So as you think about the trade deficit, remember that each time a corporation in the United States does a bond offering, that is causing it to spend more than it produces, invest more than it saves, and some of that is the trade deficit and the capital inflow that we are running from abroad.

Regarding the sustainability of the foreign debt, in the 12 months through November 2006, the latest data, foreigners increased their net holdings of longer-term maturity debt in the United States by $860 billion. No signs of difficulty for the United States in financing the trade deficit anymore than a corporation issuing bonds. It fuels growth, controls whether it has a sustainable process of investment taking place in the corporation, and takes on more debt, perhaps perpetually.

The idea that somehow the United States has to stop this process is not consistent with what a normal leveraging process is, whether for countries or for companies.

Just as with corporate borrowing, the United States needs to maintain the quality of its new investments, whether funded by United States or foreign capital. I think the focus should be on the quality of investment taking place in the United States We know we are borrowing from foreigners, usually at low interest rates. The issue: is are we using that capital wisely to build a growing economy? Yesterday's data showed that we were. In a nominal GDP basis, we are running 6 percent nominal growth year after year versus lower borrowing costs, which is a very powerful positive leverage that the United States is enjoying.

The argument that foreign funding will dry up has been made since 1984–1985. In fact, I was a staffer for the Senate Budget Committee in the previous Congressional focus on the twin deficits. I do not know if Fred testified in those hearings in 1984–1985, but there was a big concern about foreigners withdrawing their funds from the United States in that situation. And I think, it ended up without that being a particularly sensitive part of the United States economic equation.

One of the reasons for that is foreigners own a small and declining portion of overall United States assets. The data that we have discussed so far has been the foreign debt relative to United States GDP. I think a better measure is to look at the foreign debt relative to United States assets. United States assets have been growing very fast and, in reality, foreigners are losing share of the rapidly growing United States asset base in part because they are not investing enough into the United States economy.

As we talk about trade deficit numbers, remember that the data is quite suspect in many areas. For example, when a United States company produces something abroad, ships it to the United States, makes a profit on it, we count that as part of our trade deficit even though it is coming from a United States company.

A second problem with the data is that on a global basis exports and imports do not add up. One of the primary reasons is that United States exports are not counted very well. We do a really good job of counting all of our imports of goods and services but not nearly as good a job counting the exports. Most people looking at this think that our actual trade deficit is much smaller than the numbers being reported.

As we think about the risks of the trade deficit, then I will name three issues. One is we want to have the investment that is taking place in the United States be profitable. That is true whether it is from foreign capital or our own capital.

Second, protectionism, is not the right approach even if you do end up thinking that there is a concern with having the trade deficit itself.

Third, a weak dollar policy, in my mind, will not solve the trade deficit at all. It encourages capital flight from the United States and makes our overall economic situation worse.

What can be done to reduce the trade deficit? The primary burden, I think, should be on the trade surplus capital outflow countries. Remember those countries running a trade surplus are shipping capital to the United States because we have young people. How can they change to make it more attractive for that capital to stay at home? Probably more population growth, more productivity growth, and a more attractive investment climate.

As you are thinking about the problems of the trade deficit, the primary thing to be focused on is how can foreign growth and investment climates be enhanced.

I am a critic, in some ways, of our international economic policy. I do not think the United States does a good job at all in making clear to the rest of the world that we would like them to grow faster and invest more in their own countries.

A tax cut in Japan would make a lot of sense. Japan needs desperately to boost its investment and consumption and its tax rates are too high to contribute to that right now. And I think the United States should more aggressively promote prosperity abroad as part of the response to our trade deficit.

In conclusion, rather than an unsustainable situation with the trade deficit and the net foreign debt—it has been called that for 25 years with no real evidence of it being unsustainable—I think the trade deficit will continue as long as the United States grows faster than our trading partners and it will contract when we do not. It comes down to the growth rate differential that we have and it is unlikely to be narrowing.

Thank you.

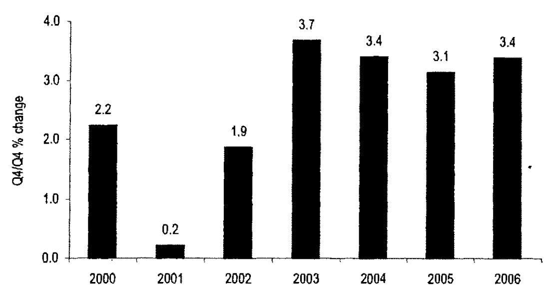
[The prepared statement of Mr. Malpass follows:]

Statement of
David R. Malpass before the
Senate Budget Committee
February 1, 2007

Chairman Conrad, Senator Gregg, members of the Committee, thank you for the invitation to testify on the current account deficit and the U.S. foreign debt. I am chief economist at Bear, Stearns & Co. Inc. The views I express today are my own and are not necessarily those of my employer.

In recent years, U.S. growth has been faster and steadier than most expectations. Even so, the frequent view has been that the U.S. is on the wrong economic path, heading into a slowdown or a recession in part due to the trade deficit. Instead, the U.S. has enjoyed a strong multi-year expansion. Growth in 2006 was faster than 2005, and 2007 looks equally robust. If so, this would make five years in a row above 3% growth. Rather than causing a slowdown, job losses or higher interest rates, the extra goods and capital inflow associated with the trade deficit have coincided with strong growth, profits and job creation.

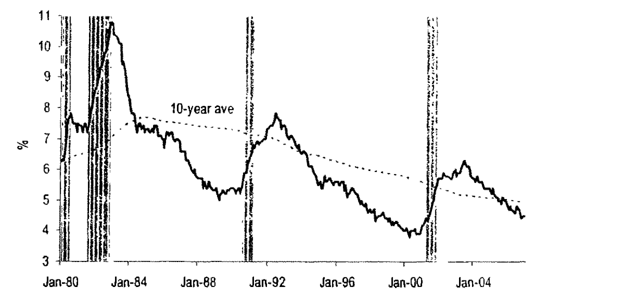
U.S. GDP Growth



Source: Haver; Bear, Stearns & Co. Inc

As the expansion has progressed, the unemployment rate has fallen to 4.5%. With over a million net new jobs added in the fourth quarter of 2006, the household employment survey may begin to show an even lower unemployment rate in 2007.

U.S. Unemployment Rate

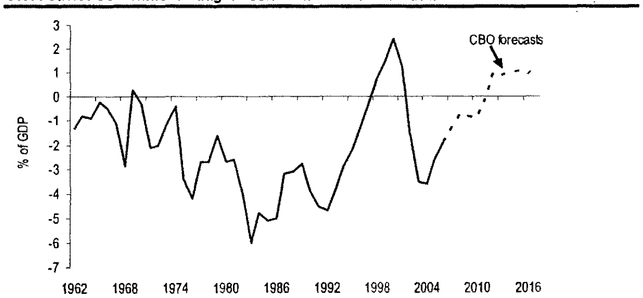


Source: Haver; Bear, Stearns & Co. Inc.

U.S. housing weakened in 2006, but this was after two particularly strong years in 2004 and 2005. I expect somewhat elevated inflation rates in much of the world in 2007 given the weakness of most world currencies earlier in the decade. But I don't expect a major negative impact on growth or financial markets from the related interest rate hikes, unless inflation really heats up.

Meanwhile, U.S. profits and consumption have been growing along with jobs. A welcome side-effect has been a surge in government tax receipts and a sharp decline in the fiscal deficit. The national debt held by the public has fallen to 37% of GDP. By this measure, the U.S. government debt is below average for the industrialized nations and well below the average of the euro-zone nations. The fiscal deficit has fallen to an expected 1.5% of GDP in FY2007, and CBO projects a surplus in the near-term.

U.S. Federal Government Budget Position with CBO Forecasts



Source: CBO; Bear, Stearns & Co. Inc

Trade Deficit Consistent with U.S. Growth

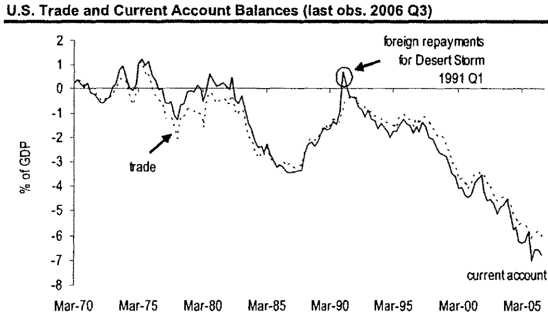
The unusual strength and steadiness of U.S. growth are hard to reconcile with the fragile-world viewpoint that the U.S. deficits are weakening the economy or creating a harmful global imbalance. I'd like to make some observations about the trade deficit, then turn to a discussion of the foreign debt.

- By definition, the current account deficit includes the merchandise trade deficit, the services surplus, investment income and transfers. For the U.S., the current account deficit is slightly bigger than the trade deficit and the gap is relatively steady, so the terms are often intermixed.

- It's normal for the U.S. to run a trade deficit. It's been around for hundreds of years of solid American growth, turning to surplus only during recessions and wars (when imports collapse) and in the brief period after World War II when the U.S. provided capital and export goods for the rebuilding efforts abroad. Normally, the U.S. brings in extra goods and capital to keep up with our growth.

- The trade deficit for the four quarters ending September 2006 was a record $779 billion (6.0% of GDP). The current account deficit for the four quarters ending September 2006 reached a record $879 billion (6.8% of GDP). Note that trade surpluses coincided with recessions. For example, the two deficits shrank in 1989 and 1990 after a shift in growth conditions favored U.S. exports over imports – the Fed funds rate rose to 9.75% in February 1989, the U.S. hiked tax rates in 1990 and fell into a recession, the Berlin Wall fell in 1989 spurring U.S. exports to Europe, Japan boomed in 1988-90, and the U.S. received foreign funds related to Desert Storm which moved the current account into surplus. **These growth factors were more instrumental in the narrowing of the deficit than the weakness of the dollar in 1985-1987.**

U.S. Trade and Current Account Balances (last obs. 2006 Q3)

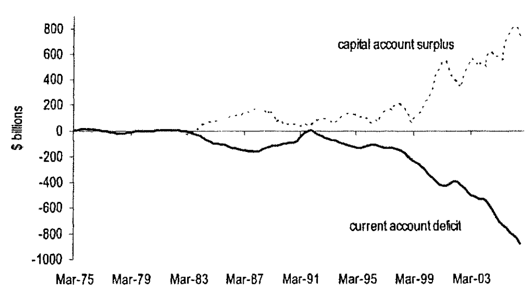


Source. Haver; Bear, Stearns & Co. Inc.

- **Countries with trade deficits often produce more growth and jobs than countries with trade surpluses.** For them, trade deficits are an indicator of an attractive, growing economy. Since the 2001 recession, the U.S. economy has created 9.7 million new jobs, compared with a 190,000 decline in Japan despite its trade surplus. Like the U.S., Spain (3.7 million new jobs) and the U.K. (1.3 million new jobs) ran trade deficits and created jobs rapidly in this five-year period. Wages are rising solidly in these three. In both theory and practice, a liberal trading environment allows more jobs with higher wages as people specialize.

- The current account deficit and the corresponding capital surplus connect foreign savings to U.S. growth, investment needs and younger demographics, creating a sustainable part of the global economic balance. **The current account deficit is large as a share of GDP because the differentials driving it are particularly large** – the U.S. has grown over 3% for four years running, drawing in imports; its investment climate is particularly attractive to foreigners; and the demographic differences are particularly favorable to a U.S. trade deficit. Absent a sharp U.S. slowdown, I expect the U.S. trade deficit to remain large until the fundamental differentials move against the U.S.

U.S. Current and Capital Account Balances (last obs. 2006 Q3)

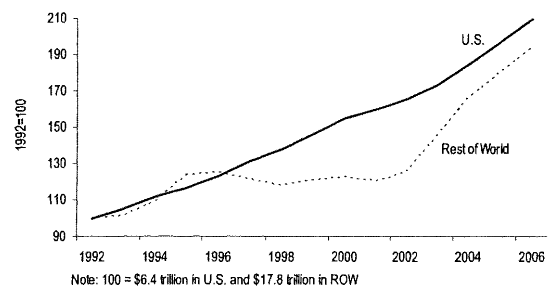


Source: Haver; Bear, Stearns & Co. Inc.

Growth Differential Contributes to the Trade Deficit

- Between 1992 and 2006, U.S. dollar GDP grew by about 110%, a strong influence on U.S. imports. That compares with dollar GDP growth for the rest of the world of around 95%, an important factor in U.S. exports. For the trade deficit to balance, U.S. imports would have to slow sharply while exports rise sharply. More likely is that the trade deficit remains wide.

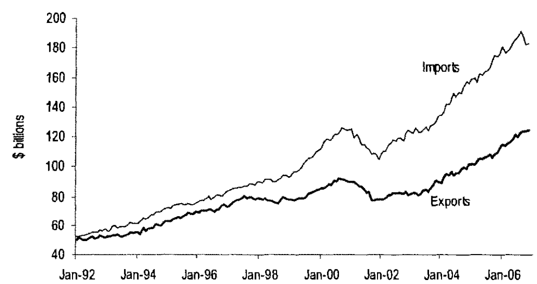
U.S. and Global GDP (last obs. 2006 est)



Source: IMF; Bear, Stearns & Co. Inc.

- U.S. imports reflect growth in the U.S. economy while U.S. exports reflect growth in foreign economies.

U.S. Exports and Imports (last obs. November 2006)



Source: Haver; Bear, Stearns & Co. Inc.

Demographic Differential Contributes to the Trade Deficit

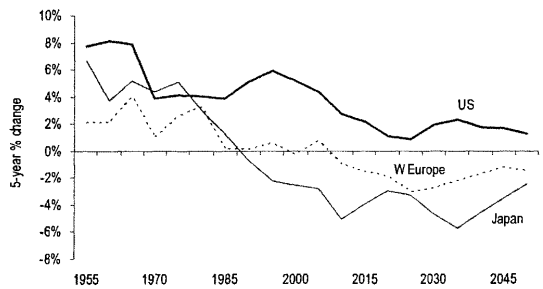
The recent surge in the U.S. trade deficit reflects, in part, the unprecedented shift in the demographics of the world's large economies.

- The under-60 U.S. population is expected to grow for at least 50 years while the under-60 populations in Japan and Europe are already declining and in China will turn down within a decade.

- Older foreigners need claims on younger people while younger Americans need capital. Foreigners want to save more than they invest in their own economies, and are eager to help us invest more heavily (through their purchase of bonds.) This makes good demographic sense. Older investors (concentrated abroad) need steady returns. Younger people (concentrated in the U.S.) need cash and debt for college degrees, houses and business startups.

- This creates a healthy synergy across generations and across borders. Japan's under-60 population is expected to decline 3%-4% every five years for a generation, creating an urgency to ship goods and funds to young people in the U.S.

Different 5-Year Growth Rates in Populations Under 60 years Old



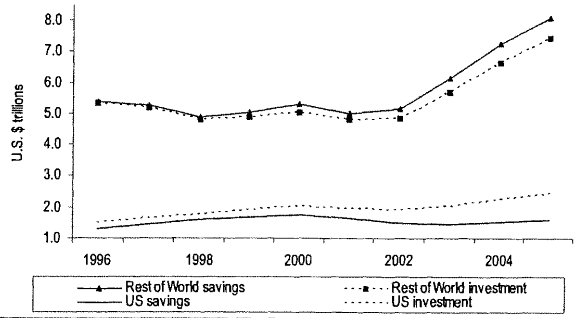
Source: Haver; Bear, Stearns & Co. Inc.

Investment Differential Contributes to the Trade Deficit

- Though widely criticized as an imbalance, the trade deficit and related capital inflow link the investment needs of the younger, faster-growing U.S. with the disinvestment process in aging, slower-growing economies abroad. Foreign savings become part of the overall pool of U.S. capital which helps fund extra U.S. investment. This adds to U.S. growth and to foreign earnings.

- In 2005, investment outside the U.S. was $670 billion less than foreign savings, while investment in the U.S. was $842 billion more than U.S. savings (roughly equal to the U.S. current account deficit). Shrinking working-age populations in the large economies of Western Europe and Japan need less investment while the expanding U.S. work force needs more.

U.S. and Foreign Investment and Savings Differential (last obs. 2005)



Source: IMF; Haver; Bear Stearns & Co., Inc.

With all the negativism about the U.S. economy, it's easy to forget its attractiveness to foreign investment. And while there is much discussion of America's heavy use of foreign capital, there is not as much of the foreign need for investments in the U.S. America's current-account deficit is matched by a capital surplus, while the rest of the world's current account surplus is matched by a capital deficit, a voluntary net flow of capital to the U.S.

International Trade Balances in 2006 ($ billions)

United States*	-$777
United Kingdom*	-$100
Japan*	$56
China	$177
Eurozone*	$125

* includes OECD estimate for 2006 Q4

Source: OECD; Haver; Bear, Steams & Co. Inc.

Trade Deficit Provides Leverage

It's frequently asserted that foreigners fund U.S. consumption. A more complete statement is that **foreigners fund U.S. investment and consumption** in the same way that U.S. funds do.

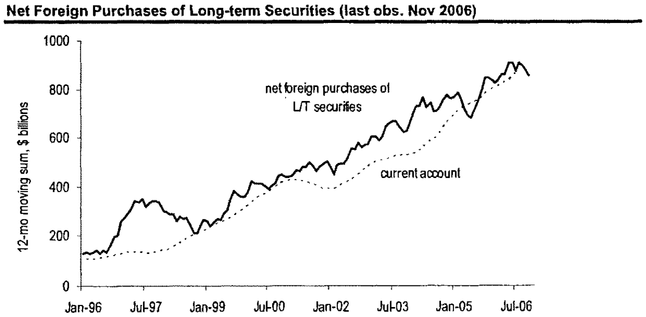
- The U.S. current-account deficit is a form of leverage in which foreigners finance the full spectrum of economic activity from consumption to home-building to R&D and capital investment. The U.S. creates gains from this incremental capital. Foreign bond purchases become part of a U.S. capital structure that produces 5%-7% annual nominal growth. The capital flow makes good sense for the elderly foreign saver who may face a low yield at home. And it makes good sense for the younger, faster-growing U.S. economy which can profit from relatively inexpensive foreign capital.

- Does the U.S. spend more than it produces? Yes. Many companies also spend more than they produce, using bonds and bank loans, some from foreigners, to make up the difference. They add employees, machines, supplies and advertising before they produce. **Growing corporations are expected to be cash hungry.** This leverage is treated as a positive for companies but a negative for countries, a key inconsistency in popular economics. Rather than paying the debt back, the growing company rolls the debt over and adds more, just as the U.S. has been doing throughout most of its prosperous economic history. Part of each additional corporate bond offering puts the company and the U.S. in the position of investing more than we save, drawing in foreign capital and contributing to the trade deficit.

The Growing Foreign Debt: Funding the Trade Deficit

Over the 12 months through November 2006, foreigners increased their net holdings of longer-term U.S. securities (equity plus debt with a maturity greater than one year) by $860 billion, providing a stable source of funding for the current account deficit.

Net Foreign Purchases of Long-term Securities (last obs. Nov 2006)



Source: Haver; Bear, Steams & Co. Inc.

- The U.S. tends to pay higher interest than many foreigners can earn locally. For example, Japan's interest rate is 0.25% versus 5.25% in the U.S. The foreigner benefits from investing in the U.S. and the U.S. benefits from using foreign capital to expand the U.S. economy.

- The total return on U.S. investment tends to be higher than foreigners earn in the U.S., since foreigners have tended to prefer lower-yielding, safer, fixed-income assets appropriate to the older demographics of foreign savers. The U.S. owns more equity and direct investment abroad than foreigners own in the U.S.

- Just as with corporate borrowing, the U.S. needs to maintain the quality of its new investments, whether funded by U.S. or foreign capital, and make sure that the return on investment exceeds the cost. This requires a flexible, private-sector-based economy paying attention to profitability and costs.

Part of the foreign-funding concern rests on the view that the market for global capital flows is a "buyers' market," meaning the potential buyer of a U.S. Treasury sets the price and yield and has the power to disturb markets by selling, or even by reducing purchases. This argument has been made without confirmation since at least the twin deficits debate of 1984-5.

- U.S. bond yields and the value of the dollar have fluctuated over a wide range in response to many factors -- U.S. growth, inflation, tax policy, and, above all, expectations of Federal Reserve rate policy -- but foreign buying and the trade deficit have simply not had much impact. Foreigners don't have much influence on key fundamentals such as Fed policy, growth, inflation, tax rates and return on investment, and aren't often a leading indicator of them.

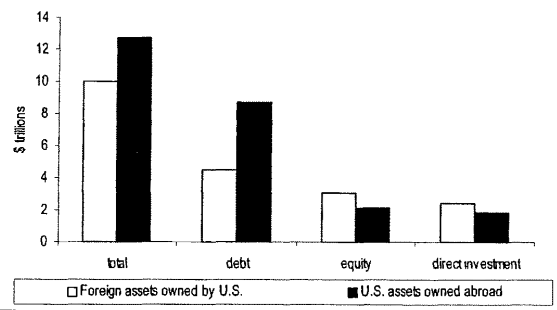
- While it's true that foreigners own a big portion of U.S. government securities, **foreigners own a smaller, declining portion of overall U.S. assets** – some $2.7 trillion (the net debtor position of the U.S.) versus $80 trillion in total U.S. assets. In essence, they have outbid Americans for Treasuries while giving up ownership share in other (faster-appreciating) assets.

- As a result, **foreign decisions account for only a small fraction of the swings in the dollar, interest rates and bond yields** – swings that are primarily caused by other factors. For example, the dollar's super-strong phase began at the end of 1996 with monetary policy's concern with irrational exuberance, and ended with the post-9/11 shift to the Fed's considerable period of monetary accommodation. The trade deficit didn't play a role.

- Likewise, U.S. bond yields fell to an extreme low in June 2003 on belated concerns about deflation, not on some newfound ease in funding the already-record current-account deficit. And the ongoing rise in bond yields reflects 2003's dollar weakness and related inflation concerns, not problems in funding the current-account deficit.

- In concept, the cumulative current account deficit creates a net foreign debt. A mark-to-market process takes account of the gains and losses in the various investments. In general, this benefits the U.S. since it tends to invest in faster appreciating assets abroad than foreigners do in the U.S. The 2005 data, the most recent available, showed that the U.S. held more equities and direct investments abroad than foreigners held in the U.S., but fewer bonds.

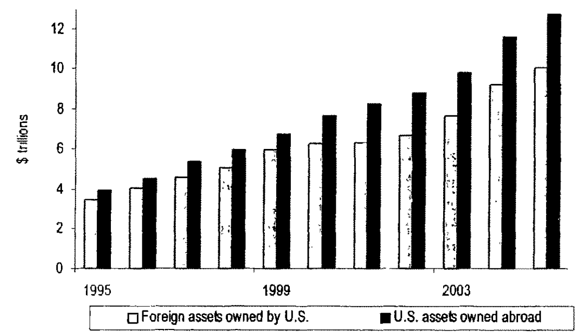
U.S. Net International Asset Position at End-2005



Source: Haver; Bear, Stearns & Co. Inc.

- While the net foreign debt of the U.S. is growing (the result of capital inflows), household net worth is growing faster, meaning **foreigners are investing in the U.S. too slowly and conservatively to keep up with our growth.** Their capital mingles with domestic savings, providing \$2.7 trillion of net international capital to combine with \$27 trillion in net U.S. household financial savings as of Sept. 30, 2006. While the U.S. reports a negative "personal savings rate", this measure arbitrarily excludes the economy's gains. **In some recent years, the one-year increase in U.S. household savings, per Federal Reserve data, has exceeded the entire foreign debt of the U.S.**

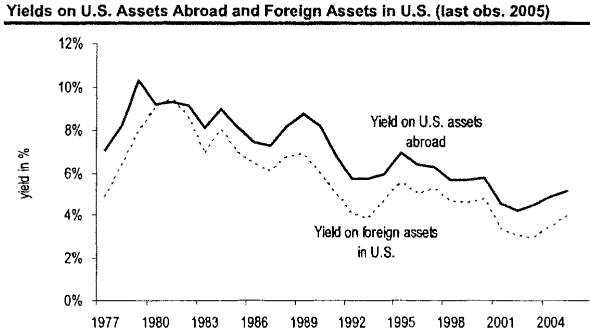
U.S. International Asset Position (last obs. 2005)



Source: Haver; Bear, Stearns & Co. Inc.

U.S. investments abroad tend to earn more than foreign investments in the U.S. Though not an exact analogy, part of the U.S. current account deficit and capital inflow is the U.S. re-circulating foreign capital back into foreign economies, paying a low, safe interest rate and earning a higher, more risky return.

Yields on U.S. Assets Abroad and Foreign Assets in U.S. (last obs. 2005)



Source: Haver; Bear, Stearns & Co. Inc.

Problems with the Trade Deficit Data

Most of my points thus far have been aimed at explaining why the trade deficit is sustainable. Many also add arguments showing that the trade deficit isn't nearly as large as the data suggests:.

- Many U.S. imports come from U.S. factories abroad, with the profits and the high-value-added jobs staying in the U.S.

- Import and export data don't take into account the jobs, value-added, or profit associated with those transactions. The U.S. tends to import many low-value-added products while exporting high-value-added products. **Rather than the trade balance, the bottom line should probably be job, income, and profit growth, all high-scoring categories for the U.S.**

- U.S. imports are counted more carefully than exports. It's likely that U.S. export data substantially understates actual exports. A large part of the discrepancy between the sum of global imports and exports is often attributed to the undercounting of U.S. exports.

Risks of the Trade Deficit

- The real challenge to the U.S. trade deficit is the same as the challenge to U.S. leverage – profitability. Whether this is a problem depends more on small U.S. businesses, not economics. To date they have been an efficient user and deployer of global capital. As a result, U.S. growth accelerated as the trade deficit expanded in the 1990s and 2000s. With its trade deficit, the U.S. gets new, profit-oriented investments and growth, drawing in imports. Foreigners get better investments than they could at home, often buying low-yielding U.S. government securities to meet their needs for safety, long maturity and yield.

- The fixation with the trade deficit encourages protectionism in the U.S. and leads to an underestimate of the power of the American economic model. We should spend less time analyzing trade deficits and more time removing obstacles to investment and innovation both in the U.S. and abroad. The economic focus should be on sustainable growth and rising living standards, which often lead to a trade deficit.

- The second risk is that the rising trade deficit will encourage Washington to adopt a weak-dollar policy. As currencies weaken, the losses outweigh other investment considerations, forcing capital flight. Rather than produce an "improvement in competitiveness," as some claim, a weak-dollar trend would more likely slow U.S. investment and economic growth. The trade deficit might improve as imports sag, but jobs and living standards would decline.

Reducing the trade deficit

- To reduce the trade deficit requires a narrowing of the differences driving it – slower growth in U.S. GDP, population or investment, on the one hand; or faster growth in foreign GDP, industrialized country populations, or investment on the other. No one should want to take the first approach. We grow our economy and population faster than our trading partners (which draws in imports) and provide more attractive investments (which brings in foreign capital). Thus, the primary burden should be on the trade-surplus, capital-outflow countries to enhance their economic climes, not on us to diminish ours.

- The trade deficit probably wouldn't respond much to a weaker dollar unless it changed these differences (for example, by pushing us into inflation and a recession.) Yen strength hasn't dented Japan's trade surplus, and it took a recession to create our last trade surplus in 1990-1991.

- Two ideas to reduce the trade deficit in a healthy way: a tax cut in Japan to boost investment and consumption there; explicit U.S. promotion of prosperity in developing countries. Our current policies are based on austerity abroad – weak currencies combined with trade and fiscal surpluses. This holds down their imports and pushes their capital into the U.S.

- Rather than unsustainable (it's been called that for 25 years), I expect the trade and current account deficits to expand to the extent that the U.S. grows faster than our trading partners and contract when we don't.

Chairman CONRAD. Thank you.

Let me start, if I can, with you, Mr. Malpass. We are talking here about twin deficits. Trade deficit, you have really focused on that. We are also talking about budget deficit and we are talking about the long-term fiscal challenges facing the country, because that is the distinctive purview of this committee and responsibility to our colleagues.

With everything that you have said, do you have any concern about the long-term fiscal situation of the country with respect to the budget deficits and the retirement of the baby boom generation and what we see it as the long-term fiscal outlook?

Mr. MALPASS. I think in the long run it is hard to project deficits. One thing we find is that they are very sensitive to growth rate assumptions. Since I tend to have a pretty optimistic view of the United States future, I think that we will find ways to meet most all of the commitments of the Government.

The problem, though, becomes when the Government makes expansive commitments, and those are presenting challenges now, particularly in the Medicare realm. We have made a big promise to the elderly about a broad, sweeping, robust, very generous health care program. That is going to be incumbent on the United States then to have a flexible, liberal, small-business-oriented growth environment and just keep growing 3 percent a year, as we have been these last 5 years.

Chairman CONRAD. I would say this with respect to Social Security, if the economy grows in the next 20 years as it has in the previous 20 years, 80 percent of the projected Social Security shortfall disappears. So I think that should be something that colleagues keep in mind as we talk about Social Security.

That is not the case with respect to Medicare. With respect to Medicare, the long-term projected shortfall is seven times the projected shortfall in Social Security. And in my judgment, when I look at the numbers to try to pierce the veil, I think that is the 800-pound gorilla here. And that has the potential to swamp the boat.

Your reference to Medicare, perhaps we are on the same wavelength with respect to that long-term challenge.

Mr. MALPASS. Yes. I think there is a big modeling issue. If current trends continue, there is a big Medicare problem.

If you look at the assumptions underlying the Medicare Trustees reports and so on, one thing that is notable is that they assume that the real rate of growth of medical services will continue. Meaning that people will go to the doctor more and more often, they will use more and more services apart from their age. One of the ways that we can see a little more daylight on the Medicare side is if we think that the systems will become more productive and that people may become satiated with their use of some of the medical services over time.

Chairman CONRAD. OK.

Let me turn to our other witnesses, Dr. Bergsten and Dr. Cline.

And ask them, you have listened now to Mr. Malpass. Anything that he said that you would want to take issue with or have a different point of view.

Mr. BERGSTEN. Yes, I have several things, but two big ones at the start.

David said that it is natural for the United States to run a trade deficit. As I said in my testimony, I do not disagree with that. The issue is how big. I suggested that if we cut it to roughly 3 percent of GDP, I would be modestly confident that we would be able to sustain it. That is because, as we said before, it would level off the ratio of net foreign debt to GDP and keep it from escalating forever.

So the difference between us is really over magnitudes, not signs. And I am not saying we should try to run a trade surplus.

Second, it is just wrong to day, as he said right at the end, that there has been no real evidence of unsustainability for over 20 years. Why did Jim Baker call the Plaza Agreement 1 year after the time period David cited, 1985? Jim Baker called the G–7 together and insisted that they cooperate with the United States in a huge adjustment of our external imbalance.

There were two reasons for that. The most immediate was that Congress was about to go protectionist in a big way. My friends on the Ways and Means Committee at the time said that if the Smoot-Hawley tariff itself had come to the floor in 1985, it would have passed overwhelmingly.

That was because Reaganomics—and I am not being political, I am trying to be analytical—big fiscal deficits and very high interest rates pushed the dollar to such high levels that the United States shifted from being the world's biggest creditor to the world's biggest debtor. Not only was there a risk to our international financial position but also there was a domestic political unsustainability because of the adverse effect on manufacturing, agriculture, and many other parts of the economy.

And so Jim Baker literally insisted, from a United States interest standpoint, that the world agree to a huge decline in the dollar. The rest of the world said it would do so only if the United State did something about the budget and that, in fact, was a partial component of the solution.

But that immediately showed the unsustainability. Again in the early 1990's, the dollar—people forget this—fell to its all-time record lows in 1994 and 1995, when Bob Rubin was Secretary of the Treasury talking about the strong dollar, again because the imbalances were rising and there were doubts about the U.S. position.

So there have been big fluctuations in our international position. David did not say this, and I do not want to put words in his mouth, but I think he implied that there has been a steady increase in external imbalances, external debt and the like, indicating that all of this is OK. That has not been the case at all. There have been very large fluctuations. After the dollar came down and the budget was corrected at least a bit in the late 1980's, United States current account deficit basically disappeared in the early 1990's. And then it started a rising trend again.

But over the last 5 years, as both Bill Cline and I indicated, the dollar has again been coming down. Fortunately it has been gradual and orderly. But again, it is an indicated that even though the foreign capital continues to come in, they want a better price. They want to be able to buy the dollar cheaper.

Chairman CONRAD. Let me just stop you there and say that we have gone over my time. I want to turn it over to Senator Gregg.

But I did want to say to Mr. Malpass, when you are talking about debt to GDP coming down, you are talking about publicly held debt. And remember, that is the baseline. When we add back the things that are left out of the baseline, we get a different picture emerge.

And certainly on gross debt, on gross debt quite a different picture emerges. And that is where we are concerned, I can say Senator Gregg and I and other members of this committee, especially given the fact we have this baby boom generation coming. That is where we think we have to make an adjustment.

Senator GREGG.

Senator GREGG. Thank you. This has been a very interesting panel.

And I think what it shows is that the trade imbalance is an extremely complex issue. Unfortunately, it tends to get, in the political arena, simplified into catch phrases, and as a result becomes a short commercial. And it is not. It is something that has so many moving parts that it takes you three folks quite a while to explain them, and I am sure you could have gone on for much longer.

But to some extent I have always thought it came back to the basic Adam Smith theory that it is not the dollar that is important. It is the productivity under the dollar that is important. The dollar is just a representative item. It is a piece of paper. It means nothing unless there is productivity under that dollar.

I guess my question is isn't the trade imbalance a reflection of the fact, to a large extent, that the world sees our economy as the place to put their money to get the best return?

I would ask you all to react to that.

Mr. CLINE. I wonder if I might respond to that, Mr. Chairman. It is certainly the case that the attraction of our capital market is a major source of the strength of the dollar. I think, though the case has been exaggerated, there is this argument out there that there is a global saving glut because Asia and Latin America had their crises and their investment rate went down. The Chairman of the Federal Reserve, Ben Bernanke, has made this argument on other occasions.

When I parse that particular argument, I get a much smaller effect, only about 0.7 percent of United States GDP is our fair share of that excess savings. But we have had a widening of our current account deficit by 4 or 5 percent of GDP.

To me it is a much more obvious smoking gun to look at the decline in Government saving, as I say, a decline of something like 5 percentage points of GDP in the critical period.

Now David was saying that well you know, isn't it wonderful that the rest of the world that does not have anything profitable to do with its money is sending it here where we are very creative and we have good investment. If you look at net private investment in 1994 it was 7 percent of GDP. In 2004 it was 7 percent of GDP.

So it is a misleading argument to say that the reason we have this large increase in our current account deficit is that we have had this huge increase in private investment. It is, I think, rather clear that part of the problem is the decline in Government saving.

But that being said, I am a little bit concerned with precisely what you say, that we will be given enough rope by the foreigners precisely because our capital market is attractive, to well and truly hang ourselves. And what I am really asking is what does a logical consistent picture look like over a long period of time?

I challenge Dr. Malpass to tell us what his ceiling safe level is for foreign debt relative to GDP? And it has to obey the following rule: the long-term rate of foreign debt to GDP equals the current account deficit as a percent of GDP—right now 7 percent—divided by the nominal growth rate. That is 6 percent. So right now our eventual stabilization is 110 percent of GDP.

That is why we think it needs to come down to 3 percent so it will stabilize at 50 percent.

But those who argue that there is no problem have one of two things. They think the sky is the limit in terms of foreign debt for the United States, unlike all the rest of the world, A. Or B, they count on this thing naturally turning around at a comfortable time when we do not really have to do anything about it. I am not sure that that is a prudent approach.

Senator GREGG. I do not think my point was that there is no problem. My point was that correcting the problem may create issues which are going to undermine the economy and the productivity of the economy if you inflate the dollar, reduce the value of the dollar arbitrarily, or create other mechanisms that essentially make America less attractive as a place to put capital, because capital is the essence of growth and jobs.

Mr. BERGSTEN. Could I perhaps respond to that? I think it is not only a fair but critically important question. But I actually would come out the other way, depending on how the adjustment takes place, going back to some of the dialog we had earlier on. If the dollar went into free fall, if it triggered a prolonged period of United States inflation, you would be right. And I have argued that that is the ultimate thing we want to avoid, and that is why we should take preemptive action.

I think the alternative correction paths are between preemptive adjustment, mainly by gradually reducing the budget deficit and keeping the pressure off interest rates and inflation, and at some inevitable point getting a very sharp fall of the dollar that pushes interest rates up to a level that would reduce our level of investment, and therefore reduce our productivity growth, which would be very damaging to the economy indeed.

So I agree with you, but the way we manage the adjustment of the external imbalance could have a decisive effect on the outcome. And I would opt strongly for trying to preempt a dollar crash, a run-up in inflation, a soaring of interest rates where the burden of working out the adjustment would fall on the Federal Reserve and monetary policy and higher interest rates.

In a way it is back to the simple point of increasing budget deficits, putting pressure on the financial markets, raising interest rates, and such.

We have been relieved of that dilemma by the foreigners. As Bill Cline said, we have not gotten crowding out of private investment from our budget deficits because the foreigners have come in and financed the difference. And if you think that can go on forever at almost any level, then you sit back and enjoy it. And there is no doubt it is enjoyable while it happens. It is like drawing on your credit card if nobody sends you monthly bills.

So as long as it persists it is enjoyable and, of course, it is politically difficult to take any of the steps to correct it. And so the tendency is to just sit back and enjoy.

But as I said in my testimony, unless all laws of economic history are repealed, you cannot count on it and it literally could hit you just at the most unhappy and politically inconvenient time.

Senator GREGG. You want to comment on this, Mr. Malpass?

Mr. MALPASS. This is an interesting discussion. I agreed with your point that productivity in the United States, I think in terms of the quality of investment, is a key determinant of whether this goes well or not. Throughout its economic history the United States has tended to borrow money from foreigners and make a profit on that in the same way that a corporation does. A corporation issues bonds and tries to make enough extra to pay the interest on the bond, then roll it over and keep the process going. It gets older and older as a corporation and gets bigger and bigger. And that is basically how the United States has run since colonial times in terms of bringing in foreign capital to the United States and making a profit on it.

It is easy to look at the buildup of our debt. But it is important to then also look at the buildup of our assets. As we use foreign capital, we compound our assets. We have a multiplier effect going on in the United States economy. It makes the process sustainable.

The final point I will mention to you then is the demographics. This is at an extreme right now because we are at this massive crunch point where the populations in Japan and Europe are already declining. And in China within a decade, the population will roll over and begin to decline at a time when the United States population is growing rapidly. It is magnifying the normal historical behavior of the United States to borrow foreign money. We are doing it more than ever before because we are growing relative to the foreign economies.

Add to that the quality of the investment climate. We are in a world climate which is particularly favorable to what the United States does.

Mr. BERGSTEN. David just said the United States has been doing this since colonial times. Not right.

As recently as 25 years ago, as Bill Cline mentioned in his statement, the United States was the world's largest creditor country. We had built up a huge net foreign asset position. For over 50 years, from roughly the start of the 20th century, at least World War I, until literally 1980, the United States increased its net asset position.

Indeed, the previous big trade deficits in the 1980's were running down the asset position built up in the previous 50 years.

One reason it is more precarious now is that we are running these big deficits on top of already having the world's No. 1 debtor position. We do not have a cushion now. We used up the cushion in the last big run up.

We built up net assets for a long time. We were the world's largest creditor country. That came to be viewed as a natural thing because we were a rich country and we exported capital to the rest of the world. Now it has all gone topsy-turvy.

Second, David keeps making this comparison with companies floating bonds. Well yes, but not without limit. No prudent company just says it will take whatever amount of money the capital markets gives me, and find some way to use it but not worry about the buildup of its debt.

They do a very careful corporate plan, have a financial strategy, and have a finite amount they want to borrow. They do not just borrow without any limit and let it go on a trajectory that gets more and more explosive.

Third, David made the correct point that how you use the funds is critical. But, look at the increase in U.S. external borrowing over the last five or 6 years. What has it financed? As Bill Cline just said, not an increase in private investment. An increase in the Government budget deficit, which went from surplus as recently as 2001 to deficit now, and more domestic consumption. The numbers today indicate that the United State private saving rate for 2006 was minus one, the first time since 1933.

So what has the big foreign borrowing financed? A big increase in U.S. capital stock and investment? No. A big increase in domestic consumption and an increase in the Federal budget deficit. And those things, to put it mildly, are not self-financing of the imbalance for the future.

Chairman CONRAD. Senator Cardin.

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

Let me thank all of our panelists. I found this discussion to be very, very helpful. And I certainly concur with the predominant view that our trade imbalance is a matter of concern and that it is not sustainable.

And I agree that we should be taking constructive preemptive steps.

I was proud of the work that we did under President Clinton to bring the budget into balance. It was not easy, but we got it done. It had a very positive impact on the economy, and yet within a very short period of time we have returned to a situation of uncontrolled deficits, and it is very frustrating.

I am always amazed that economists rarely will mention enforcing our trade rules as a way of fixing our trade imbalance back into balance. And I preface that with the fact that I have voted for most of the trade agreements, including the most controversial ones with Mexico and China. I strongly believe that it is in our national interest to enforce our trade rules, and I do not see how anyone can justify China's practices of tying its currency to ours and say that that is not manipulation and it is not adversely affecting the fair exchange between our currencies. China has a reputation for not honoring our intellectual property issues. That has an impact on American's opportunity to penetrate the Chinese market.

I mentioned China because that is obviously the largest imbalance we have. I could be talking about Europe and its nationa's practices. And I find that America has the most open markets, which I support.

But why aren't we talking about enforcing trade policies and as a method of resolving our trade imbalances?

Mr. BERGSTEN. Senator, I totally agree with that. In fact, I spent 2 hours before the Senate Banking Committee yesterday on precisely the China exchange rate issue. Secretary Paulson testified and tried to defend the continued failure of the Administration to achieve necessary adjustment of the Chinese exchange rate. China is now the world's biggest surplus country, with a global surplus last year of $250 billion, 10 percent of its GDP. And the reason, as you say, is that they intervened to the tune of $15 billion to $20 billion per month to keep their currency from rising.

So I absolutely agree. When we talk about getting the dollar down in a gradual and orderly way, its most critical component on the other side—of course the surplus countries whose currencies need to go up—is China, not only because China is the biggest surplus country but, also because when they hold their currency down against the dollar, it prompts all of the other Asian currencies to hold their currencies down against the dollar too, because the other Asians do not want to lose competitive position against China. So they take half the world, and the biggest surplus part of the world, out of the adjustment process.

Therefore, I am for very tough action and testified yesterday that while there are still some multilateral steps we can try, there may be some unilateral steps the United States has to take to get the Chinese exchange rate to move, and to move by a lot.

My estimate is the Chinese exchange rate needs to go up about 40 percent against the dollar. That would be only 20 percent in terms of its average because other currencies would go up with it. But it needs to go up a big amount.

Without that, you are absolutely right, we will not get the kind of adjustment we need.

The other steps, in terms of enforcing trade laws, are essential, including to maintain an open policy, which I strongly support.

Most of the others will not generate big numbers in terms of reducing the trade deficit. If we got all of the intellectual property enforcement we wanted, we would get a few billion dollars of extra exports, which would be useful, and it is important and we should make every effort to do it.

Senator CARDIN. It is very important for those people who work in jobs that otherwise are going to be eliminated.

Mr. BERGSTEN. Absolutely. There are all sorts of reasons to do it. I fully agree with that as well, only to say that any of those specific trade policy measures, while they are essential, will have much less impact on the trade imbalances, the big trade deficit, than moving the exchange rates and relative growth rates and some of the other things we have talked about.

Senator CARDIN. I want to give our other two witnesses a chance to respond.

Mr. MALPASS. Thank you, Senator.

I agree with your point about enforcing our rules. And I agree with the way Fred phrased it, that we need to keep our market open and that the rules will have a positive effect, but on the margins compared to the magnitude of the trade deficit.

I am thinking it is driven by the fast growth rate of the United States, the attractive investment climate, and the demographic differentials. So it is going to be hard to address through the rule—

Senator CARDIN. I just want to make one point. We have been told that often the decisions by foreign-owned banks to purchase United States dollars are not because America is a good investment. Rather, it is because they want to make sure the market remains open and that they can penetrate it with products the way they do now, and because they have the luxury to be able to buy dollars and the capacity to do it. But it is not because of the return, it is more because of the impact of their investment on stability of the United States dollar.

Mr. MALPASS. Yes, I think central bank intervention is along those lines. They are often buying instruments that are the lowest yielding within the United States economy. They are not particularly driven by yield but by the effect on their own currency.

I have some thoughts about the manipulation side of this issue. China is maintaining a currency peg and has for a long time. So has Hong Kong, as you know, using the same techniques. But it extends more broadly. Brazil, each day this year so far, has been intervening in markets to keep the real from strengthening. Japan, over the years, has built up some $800 billion of United States treasury deposits, in part for the purpose of keeping their currency from strengthening. Russia, of course, is maintaining the same policy.

While we have tended to single out China as breaking the rules, it is actually a widespread common behavior by foreign central banks to do this.

The mushrooming of this intervention process has coincided with the very low interest rates that the United States has been running. Part of what the other countries are trying to do is not have their rates as low as the United States because they are afraid of overlending within their own economies.

The United States had a 1 percent interest rate in 2004, at a time when the economy was growing fast. That is part of the reason the foreign countries are having to buy up so many dollars. We were putting out a lot of dollars in that period.

Mr. BERGSTEN. To put a fine edge on it, most of the private foreign investment in the dollar, which is still by far the larger part of it, is probably motivated by financial return and economic considerations. But David put it very nicely, the buildup by foreign central banks is very much driven by their mercantilist interest.

To put a sharp edge on it, the China and other countries are buying dollars through their official entities as a means of subsidizing their exports and their jobs, and it is part of their development strategies. They know they are going to take a capital loss because they know the dollar will go down at some point. They never mark to market so they will not be held accountable for that. They have not suffered any international reaction either. So it is a wonderful policy tool.

But you are right to flag the point. It is not because of some wonderful financial attraction of the dollar, it is because of the export subsidy policies of the other countries.

Senator CARDIN. Mr. Cline, my time is up, so if you could be brief it would be helpful.

Mr. CLINE. Just to make the point that the subsidized currency as a form of unfair trade is a much murkier area in terms of protection than good old fashion quotas and tariffs. Whatever we do, I think it is important we try to stay within the WTO/IMF framework.

I can see, if the Chinese do not eventually change, the case for taking a countervailing duty case to the WTO on grounds that the practice is a subsidy to exports that “frustrates the intent of this agreement” which is language that is right in the GATT when it refers to exchange rates.

I was interested that Fed Chairman Bernanke called it a subsidy, that is a very loaded word which I am sure many people immediately sensed.

So sooner or later this new area of unfair trade may have to be addressed. We hopefully can get changes without going down that route. If we do go down that route, I think it would be important to try to stay within the IMF/WTO—

Senator CARDIN. I would agree with you, but I would tell you, we have run out of patience. It is time for action.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Cardin.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Would you gentlemen be good enough to give me some historic context on where you think our present current account deficit is vis-a-vis other moments in our history where we have run significant current account deficits? Mr. Cline?

Mr. CLINE. Yes, I have a chart—

Senator WHITEHOUSE. Dr. Cline, my apologies.

Mr. CLINE. I have a chart on page two of my book which shows United States current account balances as a percent of GDP from 1869 to 2004. We were in deficit from 1869 to about 1877. Then we were more or less in balance through 1914. Then we were in surplus from 1914 until 1979, with the occasional exception. The surplus was 6 percent of GDP in 1917. It would seem to be an average about 1 to 2 percent of GDP during that extended period.

We only began this period of secular deficits in basically the 1980's. We have had two cycles. We had the big cycle with the overvaluation of the dollar in 1983–1984. Then there was a correction by 1990 and we were back to balance in 1990. And then we have had this second cycle, which has shown a steady widening to 7 percent.

Senator WHITEHOUSE. So fair to say that from the point of view of history, at least since the Civil War, we are running the biggest current account deficit we ever have by a significant margin?

Mr. CLINE. That is unambiguously true.

Senator WHITEHOUSE. With respect to how that corrects, you have talked about the hard landing scenario and the soft landing scenario. There was an article some time ago that I remember, I think it was written by James Fallows, that was in the form of a memo to the president looking backward on the consequences of a hard landing. Do any of you remember that article? It was in Atlantic or Harpers, one of those magazines. No?

In terms of the brutal correction that Dr. Bergsten referred to as a potentiality, in terms of the likelihood of whether we are going to have a hard or a soft landing, how would you advise us at present that likelihood shakes out? Is it a 1 percent chance of a hard landing or a brutal correction? Is it kind of 50/50 now? What is your educated guesstimate on what the likelihood of is of the brutal correction versus the soft landing?

Mr. BERGSTEN. I still think it is better than 50/50 that we can achieve a soft landing because the economy is basically strong and there is not such a huge attraction for capital in Europe or Japan, including for some of the reasons David Malpass said.

And if the dollar did start to go into a free fall, the G–7 and the Asian countries, I think, would come into the market with official intervention to try to slow it down. Neither we nor they would want to see a crash. So there are defenses against it, and I think that is the more likely case.

However, that is premised on our not doing something ourselves that would trigger a substantial loss of confidence in the dollar and our economy, such as a renewed explosion of budget deficits. The issue we are talking about here has the potential to move in either direction.

Now all sorts of other things could happen. If the world lost confidence in the Federal Reserve, which again I do not anticipate, but if that were to happen; if for whatever reason—higher energy prices or the dollar decline itself—United States inflation were to crank up. David Malpass shared some of the concerns about inflation perking up—if all that were to be seen as likely and being sustained, then that would erode a lot of foreign confidence in the dollar.

If the other key surplus countries like China took the advice to shift the focus of their own growth strategy away from relying on exports to relying on domestic demand, they would not need to subsidize their exports so much. So that buildup of foreign official holdings would decline.

In short, there are a lot of possibilities for converting it from what I still think is more likely, which is a soft landing, to a hard landing for us to be complacent and fail to take preemptive action.

Senator WHITEHOUSE. I guess the last question on this, to what extend do you all believe that the prospect of a hard landing is one that could strategically be triggered by an outside economy or an outside government, for instance China? And to what extent do you think the threat of that is realistic in the foreign policy perspective? Are we vulnerable to that. Or are the checks and balances that you referred to such that there really is not anything that a government could realistically do to trigger a hard collapse if very adverse relationships began to develop and they were using it as a strategic vehicle?

Mr. BERGSTEN. They certainly could do it. They certainly have the wherewithal to do it.

Senator WHITEHOUSE. And consequently, the wherewithal to threaten seriously.

Mr. BERGSTEN. Right, so it is not idle to worry about it. However, that is one of the things I worry about least, because it is hard to see what the motivation for any foreign country, be it an ally like Japan or a potential adversary like China, to drive down the exchange rate of the dollar. Yes, they could do us some damage, but they do themselves a lot of damage, too. They would trash the value of their remaining horde of dollars. More importantly, they would drive down the dollar against their own currency, hurting their export competitiveness and their subsidy.

Central banks, who hold these dollars in virtually every country around the world, have a fundamental mission of avoiding financial disruption for their own countries and for the world. So it is very hard to see the scenario under which any of them would do it. But they do have the wherewithal.

And I will go back to what Senator Conrad said at the start, rumors of such action can destabilize markets. The big dollar decline in the 1970's was triggered in part by rumors that Kuwait was going to sell $100 million of its dollar holdings. We never found out if they did it, or even thought about it, but rumors thereof are important.

And the chairman showed an FT article that noted that even some talk in that direction by Chinese officials could bring the dollar down.

When people say the dollar fell sharply as a result, usually it is 1 or 2 percent. It is not very serious. And since we need a somewhat lower dollar for competitive reasons anyway, I do not worry about that. But it is true that such rumors could trigger market sentiments, which, if they snowballed into the private investors, could start the free fall and hard landing I talked about.

But if you ask analytically where significant downward pressure on the dollar most would come from, my view is overwhelmingly from the foreign private investors, not the foreign officials. If the foreign private investors lost confidence in the dollar for the reasons I was suggesting, then you could get the big dollar decline. There has been a big dollar decline once a decade for the last four decades. And it has always been triggered by private foreign investors.

Senator WHITEHOUSE. Because they do not have the export externalities, if you will.

Mr. BERGSTEN. Exactly. And so they decide that, the euro looks better.

I mentioned one point in my testimony that I have not had a chance to mention orally, and it is important. The creation of the euro is a big structural change in the world financial situation. One reason it has been easy for the United States to finance its deficits for the last 25 years since it has been running deficits is the dominance of the dollar in world finance. And the reason the dollar has been dominant in world finance for a century is that it really has had no competition. There has been no other currency based on an economy anywhere near our size or with financial markets anywhere our size.

That has all changed with the creation of the euro, which is based on an economy almost as big as ours, with more trade and more financial reserves. So there are now two global currencies. In fact, in the last couple of years there has been more flotation of bonds in euros than in dollars; more euro currency is now held around the world than dollar currency.

The potential therefore to move out of the dollar elsewhere or just to put those new investments every year into another currency is now very different than it has been for the whole earlier period of our external imbalances.

The role of the euro is steadily creeping up vis-a-vis the dollar, taking more market share from the dollar in world finance. And that pace could accelerate very sharply if people, for whatever reason, lost confidence in the United States and/or if the Europeans started doing better. If in Europe productivity picked up like it did in the United States in the mid-90's, and there is no reason it should not happen at some point, then you could see a big flood of investment going into the euro. A lot of that investment would come out of the dollar or at least would prevent new investment in the dollar. And then you could get—a sharp enough decline in the dollar to cause us real trouble and propel a hard landing.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

One thing I would just like to mention is well, we have been advised now there will be three votes at 11:55 and I want to make certain that Senator Sanders has the time that he deserves with the panel.

One other observation I would make, to take this back to a budget context, because we have kind of veered off into mostly talking about the trade imbalance, which is critically important. It is the two of them in combination that I think has to concern us.

And in the budget context, the thing that we have to be most concerned is the dissavings by the United States created by large increases in the Federal debt and this tremendous run-up that we forecast with the retirement of the baby boom generation.

And it is, as you said earlier in your testimony, Dr. Bergsten, it is that effect that we have to be concerned about in terms of this committee's jurisdiction and we have to focus on.

I think even Mr. Malpass would agree that is a place where we have a special responsibility.

Senator SANDERS.

Senator SANDERS. Mr. Chairman, I apologize for being late and I welcome our panelists. I am sorry but I have not figured out yet, as a new senator, how to be in four places at exactly the same time. So I do apologize.

This issue that you are discussing, actually, is one that I consider to be of enormous importance and of great interest to me.

I would like to make a brief presentation and then I would like to ask you a kind of dumb bunny question, if I might. My presentation is this: it seems to me at least, as somebody who had been in the House of Representatives for 16 years, was there in the beginning of NAFTA and that debate, that corporate America and the corporate media was very solidly and is very solidly behind unfettered free trade. We were told from the beginning of NAFTA and PNTR with China that this is really going to be a good thing for American, in the sense of creating good paying jobs in this country, reducing our trade deficit, dealing with immigration, et cetera, et cetera.

It seems to me that the evidence is quite overwhelming that what we were told by corporate America and by Presidents Reagan, Bush I, Clinton, Bush II, was going to happen, in fact has not happened. That the reality is not only that today we have a trade deficit of over $800 billion, of great concern to everybody, we have lost 3 million good paying manufacturing jobs.

Mr. Chairman, I do not know about North Dakota but in the State of Vermont in the last 10 years one new company has come into our State which is providing very good paying jobs. One new company in 10 years. I do not know how different it is in North Dakota.

I was in China 5 years ago and, as all of you know, China is exploding. You cannot walk into a town without seeing a huge amount of building activity and so forth and so on. In my State, a small State, not a manufacturing State, we have lost 20 percent of our manufacturing jobs in the last 5 years. One out of five of our jobs.

We are losing good paying jobs. Most of the new jobs that are being created pay lower wages than the jobs that we are losing. We are running up a huge trade deficit. There is speculation, for example, that the automobile industry in the United States may be in China in 20 years.

My dumb bunny question is in the midst of all of that reality of the decline of the middle class, the increase in poverty, the loss of good paying jobs, the growth of our trade deficit, why is anybody continuing to defend our current trade policies? And why are people not saying excuse me, it is not worked, we need to rethink them very fundamentally? Dr. Bergsten?

Mr. BERGSTEN. The huge trade and current account deficits cannot really be attributed to trade agreements. They can be attributed to these big macroeconomic imbalances that we talked about, including the exchange rates.

I spent 2 hours before the Senate Banking Committee yesterday talking about the Chinese exchange rate and laying out a very aggressive program for attacking it, including with unilateral U. S. action if needed, because that exacerbates the problem so enormously.

Senator SANDERS. But let me ask you this, and I share that concern. But if you are an employer in North Dakota or in Vermont and you can move to China and hire people, hard-working good people, at 50 cents an hour, you do not have to worry about unions, you do not have to worry about environmental protection, why would you not do that?

Mr. BERGSTEN. The reason you would not is because the productivity of those Chinese workers is, in most cases, equally lower than their wages.

Senator SANDERS. I do not believe that.

Mr. BERGSTEN. In the aggregate it is true. But, I will grant you in some sectors it is not true, and that incentive exists in some sectors.

Senator SANDERS. The people who run companies like General Electric are not dummies. When you have the CEO of General Electric saying that he sees the future of GE in China, or when you see white collar companies, information technology companies, moving as fast as they can to India, I understand the productivity in the United States is going to be higher in China. But if I am paying somebody 50 cents an hour, as opposed to $15 an hour or $20 an hour, I could compensate for that. If you work half as effectively I still make a lot more money. And the proof is in the pudding.

Mr. Chairman, how many new plants have been built in North Dakota in the last 10 years?

Chairman CONRAD. I do not know how many new plants. We do not have—we are very different, on almost any national metric, North Dakota is different.

[Laughter.]

Chairman CONRAD. We have had an increase in manufacturing in North Dakota but that is an unusual set of circumstances that relates to—you know, most people do not think of North Dakota as an energy state, but we are. So that changes things.

Senator SANDERS. But in Vermont, and I think in the Northeast, what I am telling you is truth. There has been one major plant that has come in.

My point gentlemen, and I would love to hear other discussion on it, is I think what has been distorted is you have—I remember, Mr. Chairman, because I was here for the NAFTA debate, every major newspaper in America editorial, down to the Toledo Blade, supported NAFTA. And I do not know how much change there has been in mentality. But I think if you look at it objectively, it is very hard to defend from the standpoint of the middle class or working families of this country, our current trade policy. I think more and more Members of Congress are beginning to understand it. Certainly the American worker understands that.

But other discussion on why, at this point, somebody should say oops, we made a mistake. We have to rethinking this. And not just blue collar. I worry about white collar information technology jobs, as well.

Any other comments, I would appreciate it.

Mr. CLINE. If I might, I think it is fairly important to remember that Americans, the modest income households in this country also get a tremendous benefit from the availability of goods at bargain prices. Their real incomes would be considerably lower if we had protection like we used to, sky-high protection on apparel, for example.

But I fully agree with my colleague, Fred Bergsten, that these huge widening trade deficits have much more to do with our macroeconomic policy, our fiscal policy, with exchange rates than they have to do with any massive change in our trade policy.

There are other industrial economies, Europe is not in a situation of big trade deficits because of low-wage foreign competition—your way of looking at it, which is an understandable initial approach. But if you parse it through, it seems to me it would imply that, of course, Europe and Japan would have tremendous deficits because they, too, have industrial country wages, in many cases higher than our wages. And neither can they compete with China.

Well, we know that is not true. Europe actually had a surplus. It is about in trade balance. Japan has a huge surplus.

I think you have your finger on the right concern, that the external sector is making life harder for American manufacturing than it need be. But I do not explain that because of NAFTA, and I do not explain it because of low wages in China. I do attribute to the constellation of macro policies that have led us to where we have the largest external deficit in our history.

Senator SANDERS. My last question, and thank you for the time, Mr. Chairman, is worker productivity in the United States has risen quite rapidly. And yet in the last 6 years real wages or median family income has gone down, workers are working, in many cases, longer hours for low wages, poverty has increased substantially. Why? And how can that not have something to do with our trade policies?

Mr. CLINE. If my colleagues will forgive me, let me address that, too. Because I did a book in 1997 called Trade and Income Distribution. And it tried to parse out what was the role of trade and other factors in the rising wage differential between skilled and unskilled workers. And that had been going on since the 1970's.

My conclusion was that we should have expected that wage differential to decline because we had a huge increase in the supply of skilled workers from universities cranking out graduates. Instead, it increased.

So there must have been large unequalizing forces. And the bulk of the unequalizing force seems to come from technological change that shifted out the demand for skilled workers more than the supply had shifted out.

My calculations did show some modest further contribution from open trade, but it was much less important, far less important, than the technological change. And also, a very substantial contribution from the erosion of the real minimum wage and from the erosion of unions, de-unionization in the country.

So I think there are a number of factors that have given us this uncomfortable period of a widening of the income disparities. I think it is wrong, though, to think that trade is the most important of those.

And I would reiterate that trade protection hurts the consumers who are buying a lot of goods that are imported at prices that otherwise would not be available.

Senator SANDERS. I do understand that, but I have a real fear that a great nation is not going to be a nation where millions of low-wage workers go to Wal-Mart. I do certainly agree with you. You can buy products very, very reasonably at Wal-Marts and other stores, no question about it.

But that is not, I hope, what the future of American is, that we have workers who are working at low wages who survive by buying cheap labor made by people who make 30 cents an hour abroad. I would have a different vision for America.

Yes, sir.

Mr. MALPASS. Thank you, Senator Sanders.

I wanted to underscore Fred and Bill's points, and would agree with those in diverting the attention from the trade agreements into the macro climate.

I do not think it is a fair characterization to describe the United States as headed in the direction that you are saying. This is a vibrant economy that is growing fast, that is creating a lot of well paying new jobs.

The challenge is the amount of change going on in the United States Each quarter there is a tremendous number of Americans that leave a job and go to a new job.

One of the things happening has been a migration from New England to the South. I am from New York State. New York State is losing population each year, and quite dramatically, at a time when the rest of the country is adding population. That creates particular strains.

We can think in terms of transition assistance for people migrating to different parts of the country or different types of jobs. I think that we have to put some of these concerns into the overall manufacturing transition of the United States economy to services. In many ways, the United States is ahead of the rest of the world in doing the products of the future rather than products—you mentioned automobiles—the products that were invented a long time ago.

One final point—

Senator SANDERS. I am not quite clear on what that means. Manufacturing jobs are in decline in the United States; is that correct?

Mr. MALPASS. Yes. That decline has actually been a straight-line process for 50 years.

Senator SANDERS. And the new jobs, service industry jobs—I am not an economist, but my impression is—pay substantially less than manufacturing jobs?

Mr. MALPASS. No, I do not think that is correct.

Senator SANDERS. Service industry jobs, working at Wal-Marts does not pay less than working at General Motors?

Mr. MALPASS. That would be correct.

Mr. BERGSTEN. Working at Goldman Sachs.

Senator SANDERS. Goldman Sachs is a service industry jobs?

Mr. MALPASS. On average, services jobs pay more than manufacturing jobs.

Senator SANDERS. Waiters and waitresses? I mean, I guess the problem is working at Goldman Sachs they are going to get a $50 billion bonus. Do we equate that in the same category as working at McDonald's, does not make a lot of sense to me.

Mr. BERGSTEN. No, but workers in the big services sectors—hospitals, health care, education, teachers, administrators, and government employees. Those are the big parts of the services sector. And even some retail and wholesale trade jobs actually pay pretty well.

You are right, of course: A hamburger flipper or a low-wage janitor are services jobs as well. But so are some apparel and footwear workers, who to the extent that they still exist get very low wages as well. But services, on average, do pay higher than manufacturing jobs. And that is fortunate, since that is 80 percent of the work force now.

Mr. MALPASS. May I add one more point? You raised the median income issue.

We have gone through a remarkable 10-year period with the swing in the value of the dollar. Some portion of the median income weakness of these last 5 years has been related to this. As the dollar weakened in 2001, 2002, and 2003, with low United States interest rates, commodity prices went up a lot. Wages are just now beginning to go up as much.

There is a timing cycle that is adding to this sense of the median wage being weak. The first prices to adjust, after a big devaluation of the dollar as we have gone through, are for things that are not so much produced in the United States That is going to have a negative effect on the median wage until workers catch up, which is the process we are in now.

Chairman CONRAD. Can I just say—

Senator SANDERS. Do we have a vote?

Chairman CONRAD. Yes, the vote has started, and we are probably 3 minutes into the vote. I would say to my colleague, we would give Mr. Bergsten a chance to respond and then if you would have a final question.

Mr. BERGSTEN. To be clear, we as a country do a lousy job equipping our lower-skilled, lower-educated, lower-income people to compete in a globalized economy. We have done intense studies of globalization's effect on the United States economy. We conclude that the United States economy as a whole is today $1 trillion per year richer than it would otherwise be as a result of our integration into the world economy and globalization. That is $10,000 per household.

However, it does add to the unequal income distribution. And therefore, there is a cardinal need for the country to do a much better job in K–12 education, in training programs, and in transitional safety net assistance to help the losers, which there clearly are as part of the process, to reap some of the benefits.

We gain $1 trillion a year. We spend $1 billion a year on trade assistance.

Senator SANDERS. My constituents do not gain part of that. Most of that or much of that $1 trillion goes to people very much on the top.

Mr. BERGSTEN. That may be for the next debate, but as Bill Cline said, a lot of it goes to low-income people because of those cheaper goods at Wal-Mart.

Chairman CONRAD. Let me just put a final question to you.

In terms of the responsibility in this committee, and I would just ask you to respond briefly, do you believe it is important that we work to address especially these long-term fiscal imbalances that we confront?

I would start with you, Mr. Bergsten.

Mr. BERGSTEN. It is imperative that you fashion and implement soon a decisive answer to the long-run fiscal problems. In addition to all the domestic problems it would cause, we would almost surely be triggering at some point—sooner rather than later—an external crisis that would be enormously damaging to the United States economy, United States foreign policy, and all of the objectives that you and the committee, but Congress more broadly, are pursuing.

Chairman CONRAD. Dr. Cline?

Mr. CLINE. Yes. I think it is critical. Some of the numbers are just mind-boggling in terms of the rise of Medicare and Medicaid as a percent of GDP. It is a rise from 4 percent of GDP to 12 percent of GDP or something like that. That is critical.

I would also underscore that I think even in the shorter term, three or four or 5 years, it is highly desirable to move from our 2 percent of GDP realistic deficit to something like a 1 percent surplus.

Chairman CONRAD. Mr. Malpass?

Mr. MALPASS. Mr. Chairman, and I agreed with your point that it is imperative that we do things. I will list four. One is be very cautious of new entitlements. They kind of creep up decade after decade. Also, be cautious of expanded entitlements. They quietly gather more reach.

With regard to Medicare, pay particular attention to possible efficiencies within Medicare.

And then fourthly, a glaring need is tax reform. We have a tax system that does not work, and there is no real plan to begin to fix that.

Chairman CONRAD. Let me just say that is one of the things Senator Gregg and I have tried to put on the agenda here, is a procedure that would involve eight Democrats, eight Republicans. They would be given the responsibility to come up with a plan that would involve both the long-term imbalances and tax reform and revenue issues and come back with a plan that would take a super majority of that committee to report, and it would take a super majority here to pass on a fast-track basis.

That is what we are trying to advance here. And that is a challenge in and of itself.

We are well into this vote. I just want to conclude by thanking this really distinguished panel. You have been, I think, especially interesting to the committee.

Thank you very much.

[Whereupon, at 12:06 p.m., the committee was concluded.]

HEARING TO CONSIDER WAR COSTS

TUESDAY, FEBRUARY 6, 2007

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SD–608, Senate Dirksen Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

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

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. I would bring the hearing to order.

I would like to welcome everyone to today's Budget Committee hearing on war costs. I would like to particularly welcome our witnesses. Dr. Gordon Adams, a Fellow at the Woodrow Wilson International Center for Scholars, and a former Associate Director of the Office of Management and Budget for National Security. Welcome, Dr. Adams.

Dr. Michael Gilmore, the Assistant Director of the Congressional Budget Office and the head of CBO's National Security Division, somebody who is very respected on these issues. We are glad to have you here.

And Steve Kosiak, the Director of Defense Budget Studies at the Center for Strategic and Budgetary Assessments.

Thank you all for your contribution to the work of the committee.

I want to indicate that, in addition to today's hearing, next Thursday we expect to hear from the Secretary of Defense, Mr. Gates, on the question of war costs, as well as the overall defense budget.

The Administration has been financing this war not through the regular budget process but, as you know, through a series of supplemental appropriations bills. We very much believe that these war costs ought to be considered in the regular budget process so they get the oversight that they deserve.

To do the war funding the way the Administration has been doing it avoids accountability and oversight. When we are spending over $10 billion a month, we think it is critically important that Congress conduct its oversight responsibilities.

Let me be clear, we will provide our troops with everything they need for as long as they are in harm's way. I want to be crystal clear on that point. We will stand shoulder to shoulder with those who are supporting the resources that are necessary for our troops in the field. That is a responsibility that all of us on this committee recognize.

But we will also conduct the oversight that has been lacking because these provisions have not been in a budget request.

I want to, at this moment, commend my colleague who chaired this committee previously for his vigorous insistence that these costs be included in a budget. Senator Gregg was a leader on this matter, is a leader on that matter, and I want to commend him for it.

The fact is that the Bush Administration has not shown, in its previous budgets, the full cost of the war. At one point at the beginning of the war the head of the Bush Administration's USAID said, and I quote, "That is correct, $1.7 billion is the limit on reconstruction for Iraq. In terms of the American taxpayer contribution, that is it for the United States The rest of the rebuilding will be done by other countries and Iraqi oil revenues."

He could not have been more off the mark. We have already committed $28 billion for Iraqi reconstruction, and that does not count the money for their security forces.

At another point, in testimony before the Congress, the Deputy Defense Secretary, Mr. Wolfowitz, said this "The oil revenues of Iraq could bring between $50 billion and $100 billion over the course of the next two or 3 years. We are dealing with a country that can really finance its own reconstruction, and relatively soon." That prediction was also wrong.

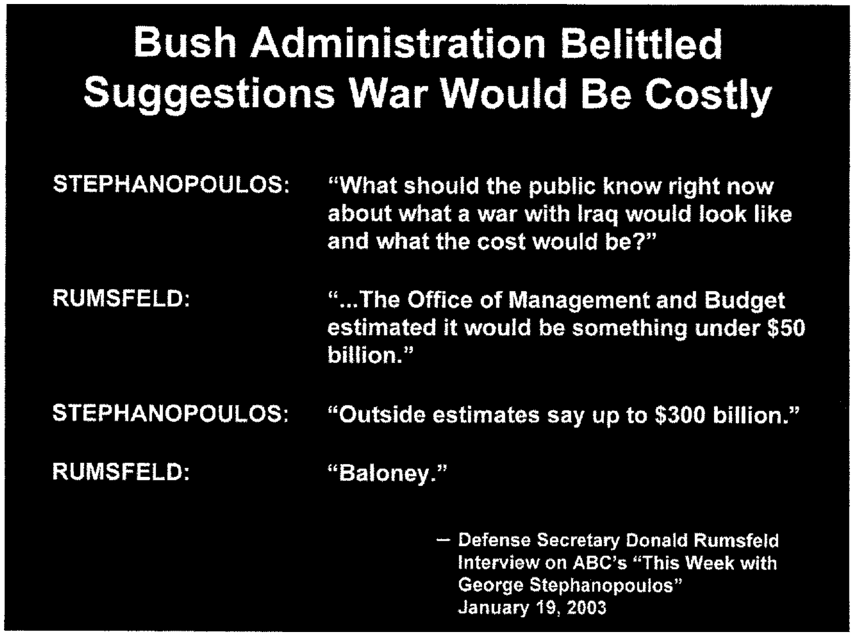
Secretary of Defense Rumsfeld was even more dismissive of predictions that the war could be costly. Here is the transcript of an interview on This Week With George Stephanopoulos.

Stephanopoulos: What should the public know right now about what a war with Iraq would look like and what it would cost?

Secretary RUMSFELD. The Office of Management and Budget estimated it would be something under $50 billion.

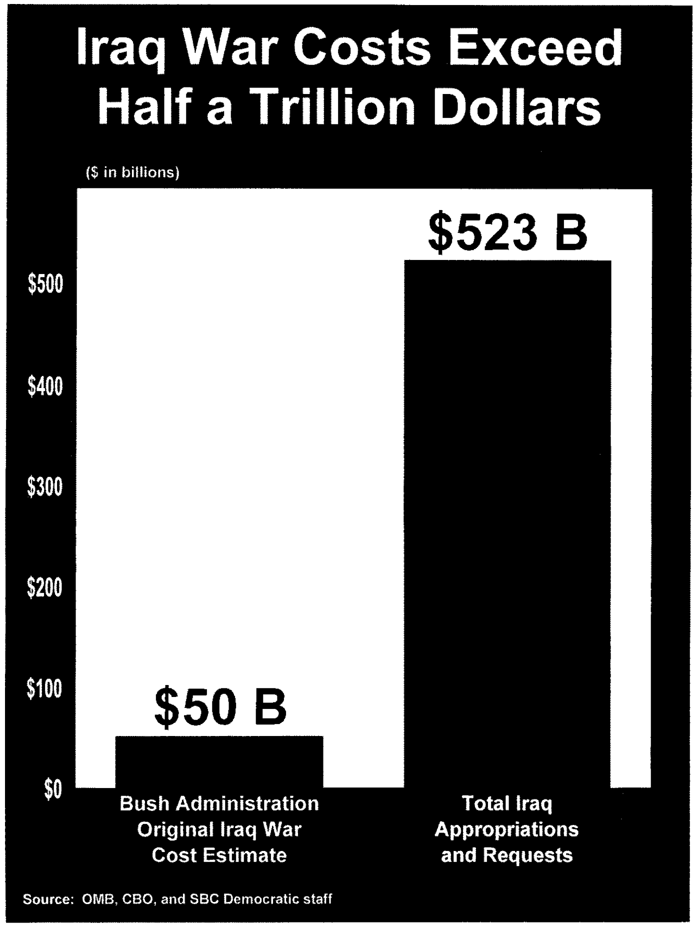
Stephanopoulos: Outside estimates say up to $300 billion.

Rumsfeld: Baloney.

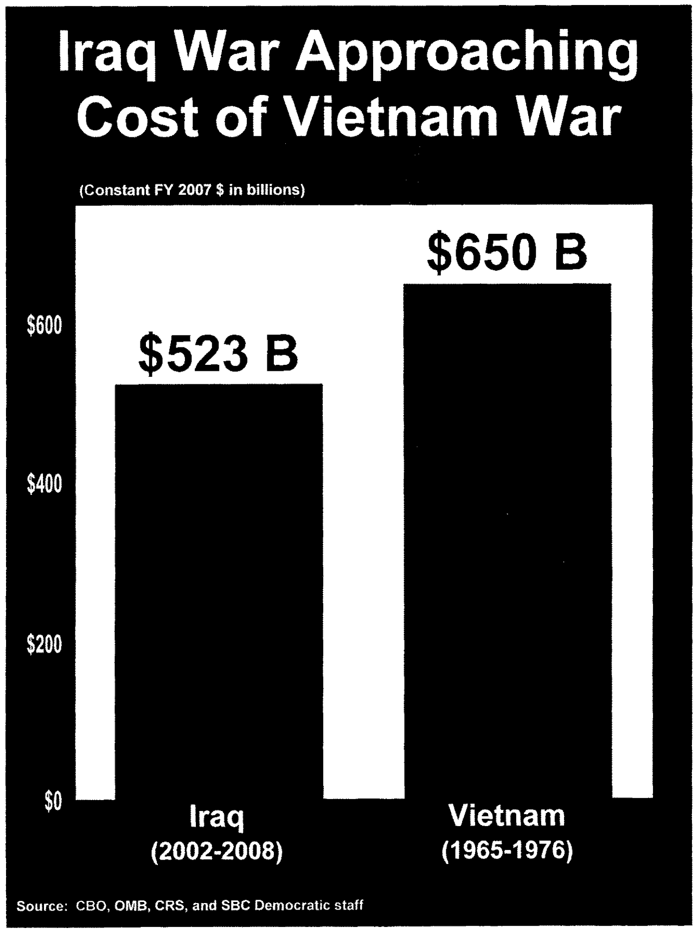


It was not baloney. We now know that the $300 billion estimate does not cover the cost of the war this far. In fact, it was far below the cost of the war to this juncture.

Including the requests in the President's budget released yesterday, the Administration has now asked for a total of over $520 billion in emergency funding on top of the regular defense budget. That is more than 10 times the Administration's original war cost estimate.

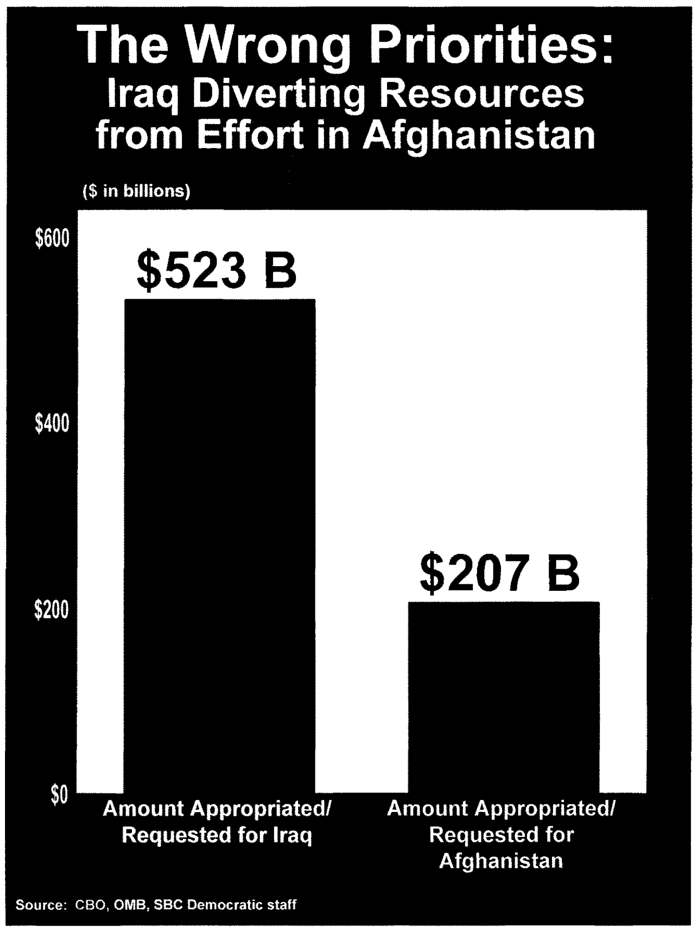


To put this cost in perspective, the Iraq war is now approaching the cost of the Vietnam War. In 12 years of major involvement in Vietnam, we spent $650 billion in today's dollars. Less than 4 years after the invasion of Iraq, we are now considering a request that will bring the total cost of the Iraq war to more than $500 billion. And that is without including the $50 billion placeholder the President included in his budget for war costs in 2009.

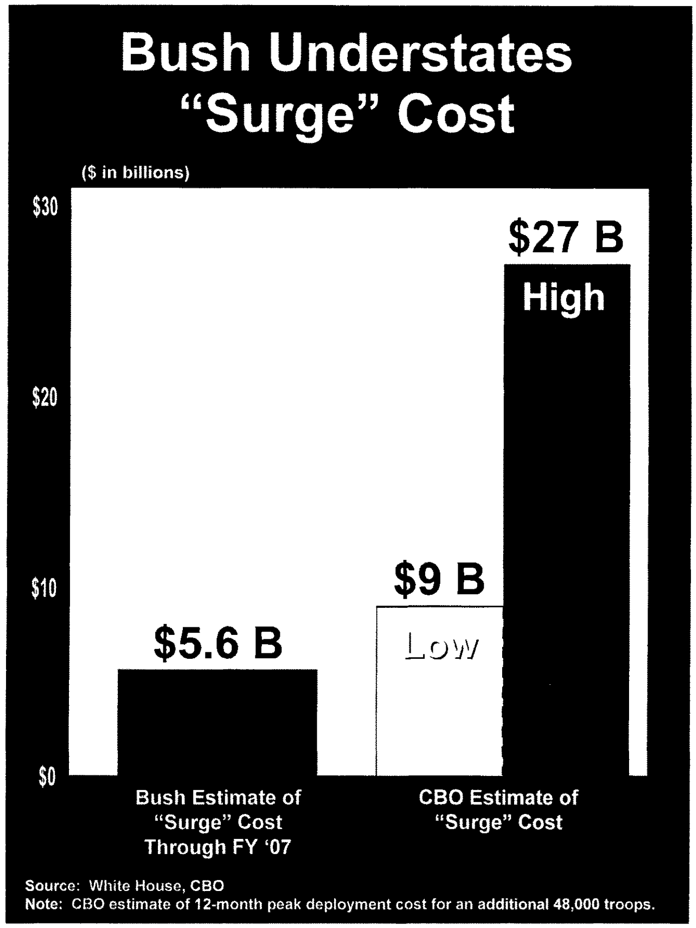


If we add Iraq and Afghanistan costs together, we are already well above the cost of the Vietnam War. Unfortunately, Iraq has diverted resources from our effort in Afghanistan. The news from Afghanistan has been troubling and disturbing. The situation there looked like it was improving a few years ago but now has deteriorated. We, I think, all understand the absolute necessity of prevailing in Afghanistan.

The budget also reflects these wrong priorities. Between what we have spent and what the Administration has requested, Iraq has received $3 for every dollar in Afghanistan. That is despite the fact that it was Osama bin Laden, based in Afghanistan, who attacked the United States and not Iraq, led by Saddam Hussein.



The Bush Administration's cost estimate on the buildup, the further buildup that he is calling for in Iraq, has also been subject to question. The Administration has indicated to us that the cost of the escalation in Iraq would be $5.6 billion. Yet last week the Congressional Budget Office informed the committees that the surge would actually cost $9 to $27 billion, depending on the duration of the escalation because the Administration was not fully accounting for the cost of all of the support troops needed.



In addition to questions about the number of support troops needed for the President's plan, there are also questions about whether our troops lack the equipment needed to get their job done. Here was a Washington Post headline last week "Equipment for added troops is lacking: new Iraq forces must make do, officials say."

The Washington Post

TUESDAY, JANUARY 30, 2007

Equipment For Added Troops Is Lacking

New Iraq Forces Must Make Do, Officials Say

By ANN SCOTT TYSON
Washington Post Staff Writer

Boosting U.S. troop levels in Iraq by 21,500 would create major logistical hurdles for the Army and Marine Corps, which are short thousands of vehicles, armor kits and other equipment needed to supply the extra forces, U.S. officials said.

The increase would also further degrade the readiness of U.S.-based ground forces, hampering their ability to respond quickly, fully trained and well equipped in the case of other military contingencies around the world and increasing the risk of U.S. casualties, according to Army and Marine Corps leaders.

"The response would be slower than we might like, we would not have all of the equipment sets that ordinarily would be the case, and there is certainly risk associated with that," the Marine Corps commandant, Gen. James Conway, told the House Armed Services Committee last week.

President Bush's plan to send five additional U.S. combat brigades into Iraq has left the Army and Marines scrambling to ensure that the troops could be supported with the necessary armored vehicles, jamming devices, radios and other gear, as well as lodging and other logistics.

Trucks are in particularly short supply. For example, the Army would need 1,500 specially outfitted — known as "up-armored" — 2½-ton and five-ton trucks in Iraq for the incoming units, said Lt. Gen. Stephen Speakes, the Army's deputy chief of staff for force development.

"We don't have the [armor] kits, and we don't have the trucks," Speakes said in an interview. He said it will take the Army months, probably until summer, to supply and outfit the additional trucks. As a result, he said, combat units flowing into Iraq would have to share the trucks assigned to units now there, leading to increased use and maintenance.

Speakes said that although another type of vehicle — the up-armored Humvee — continues to be in short supply Army-wide, there would be "adequate" numbers for incoming forces, and each brigade would receive 400 fully outfitted Humvees. But he said that to meet the need, the Army would have to draw down pre-positioned stocks that would then not be available for other contingencies.

Still, U.S. commanders privately expressed doubts that Iraq-bound units would receive a full complement of Humvees. "It's inevitable that that has to happen, unless five brigades of up-armored Humvees fall out of the sky," one senior Army official said of the feared shortfall. He expects that some units would have to rely more heavily on Bradley Fighting Vehicles and tanks that, although highly protective, are intimidating and therefore less effective for many counterinsurgency missions.

Adding to the crunch, the U.S. government has agreed to sell 600 up-armored Humvees to Iraq this year for its security forces. Such sales "better not be at the expense of the American soldier or Marine," Speakes told defense reporters recently, saying U.S. military needs must take priority.

Living facilities in Iraq are another concern for the additional troops, who would be concentrated in Baghdad, Army officials said. The U.S. military has closed or handed over to Iraqi forces about half of the 110 bases established there after the U.S.-led invasion in 2003. Decisions are being made on where to base incoming units in Baghdad, but it is likely that, at least in the short term, they would be placed in existing facilities, officials said.

Lt. Gen. David H. Petraeus, the new top U.S. commander in Iraq, has requested that additional combat brigades move into Iraq as quickly as possible. But accelerated deployments would mean less time for units to train and fill out their ranks. Brigades are required to have an aggregate number of soldiers before deploying but may still face shortages of specific ranks and job skills.

Meanwhile, the demand for thousands more U.S. forces in both Iraq and Afghanistan is worsening the readiness of units in the United States, depleting their equipment and time to train, Army officials said. "We can fulfill the national strategy, but it will take more time and it will also take us increased casualties to do the job," Speakes said.

Army Chief of Staff Peter J. Schoomaker testified last week before the House Armed Services Committee that, regarding readiness, "my concerns are increased over what they were in June."

"To meet combatant commanders' immediate wartime needs, we pooled equipment from across the force to equip soldiers deploying in harm's way," he said. "This practice, which we are continuing today, increases risk for our next-to-deploy units and limits our ability to respond to emerging strategic contingencies."

Schoomaker called for additional funding to fix "holes in the force" and "break the historical cycle of unpreparedness."

The equipment shortages are pronounced in Army National Guard units, which have, on average, 40 percent of their required equipment, according to Army data. Senior Pentagon and Army officials say they expect to have to involuntarily mobilize some National Guard combat brigades earlier than planned to relieve active-duty forces. But the Guard as a whole is not expected to return to minimum equipment levels until 2013, Army figures show.

The Army seeks to increase its permanent active-duty ranks by 65,000 soldiers by 2012, creating six new combat brigades at a total estimated cost of $70 billion.

That is a serious matter. We should not be sending our troops into harm's way without the equipment that they need. I see no indication that the President's plan will cover the costs, his budget plan will cover the costs that CBO has alerted us to.

I look forward to hearing our witnesses thoughts on the costs of the President's proposals and look forward to the chance for questions from the panel.

With that, I turn to my colleague, Senator Gregg.

OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Thank you, Senator Conrad. And I do think this is a very appropriate hearing. I wish we had someone from the Defense Department testifying, but I know it is difficult to get them to come to the Budget Committee, having been chairman and requested that a number of times.

I appreciate the Senator's comment that the troops in the field will get the support they need. Obviously, I believe that is the correct policy. I know the Senator is very sincere in his belief in that. I just wish the Majority Leader were equally sincere and would allow us a vote on that specific language this week, which appears to be something the Majority Leader is now going to allow us to do. That is a fairly reasoned position. But the troops in the field should be supported. But as of right now, the Majority Leader takes the position that the amendment should not be allowed to the floor as one of the three things we vote on or four things we vote on this week. Very strange in my opinion, inconsistent to say the least.

On this next issue, however, of budgeting for troops and our costs, I do agree with the Chairman. We have very serious concerns about the way the Administration has brought forward their budget. I will begin by congratulating them for at least including this year what they project as the full cost in 2008. I thank Director Portman for insisting on that. I do not think the Pentagon would not have done it without the Director's insistance.

However, once again they have designated it as an emergency. This is unacceptable. It is very clear, after 5 years of war, that it is not an emergency, that it is something that we have to do. We have to fight this war and we have to make sure our troops that go into this battle are fully supported with the resources they need. And it should go through the regular order. Because we have seen in a couple of the other supplementals that have been sent up that things which were not war fighting have been included. And it has been represented, at least in press reports, that that may occur again, such as the repositioning of the Army and aircraft would be purchased for the out years, and even boats that do not deal with the immediate issue of fighting the war.

So I do think this language should have the emergency designation stripped from it, and it should go forward as a sidecar. That is the way I would describe it. I do not want it folded into the core budget because I do not want, two or 3 years from now when the war does wind down and we are out of Iraq, which we all hope will happen, I do not want the defense base to have grown by the amount of the war cost. And then we have to go back in and pick the money out in order to get the defense repostured at its proper level.

I believe we should have a base budget for the Defense Department and we should have what I call a sidecar for fighting the war. But it should not be an emergency event, it should go through the authorizing process.

I will be interested in the proposal that comes forward from our Democratic colleagues, as they are now responsible for the reins of

Government, and specifically the budget. As we all know, the budget is not signed by the president, it is truly a work of the Congress, about how you are going to handle these war costs.

My own view is you need to put more in for 2009. I think the White House and the Administration has grossly underrepresented that number with a $50 billion plug. That is not anywhere near what the 2009 cost is going to be. A more correct number is probably going to be on what the historic average is, somewhere around $90 billion or $100 billion.

But it will be interesting. You have a difficult task, and I will be happy with you on that.

But I do think we should get this number right and we should give the military the dollars they need to make sure the men and women who are in the field are properly supported. And we should do it in the regular order, not outside the regular order.

I thank you for having this hearing.

Chairman CONRAD. I thank Senator Gregg for those observations.

We will now go to the witnesses, and we have asked each of them to limit their remarks to five to 7 minutes so there are sufficient time for questions by colleagues.

We will start with Steven Kosiak, the Director of Budget Studies, the Center for Strategic and Budgetary Assessments.

Welcome, Mr. Kosiak, and please proceed with your testimony.

STATEMENT OF STEVEN M. KOSIAK, VICE PRESIDENT FOR BUDGET STUDIES, CENTER FOR STRATEGIC AND BUDGETARY ASSESSMENT

Mr. KOSIAK. Thank you.

First I want to thank Chairman Conrad and the rest of the committee for inviting me to testify this morning on this very important subject.

In my testimony, I want to make four points related to the costs and funding for the global war on terror, or the GWOT. My first point is a simple one, and that is that the GWOT has proven to be very costly, and those costs have grown substantially over time.

All together, the money that's been appropriated so far through 2007, is $502 billion for the GWOT, and that includes—you can get somewhat different estimates—something like $345 to $375 billion for Iraq, $100 billion for Afghanistan, and $25 to $55 billion for a variety of other programs and activities.

Yesterday, the Administration requested another $93 billion for 2007 and $142 billion for 2008.

Assuming these two measures are enacted, total funding for the GWOT would rise to about $737 billion through the end of next year. That would make the GWOT more expensive than either the war in Vietnam or the war in Korea.

GWOT funding is not only high today, it has been growing significantly over time. Back in 2001, when we first sent troops into Afghanistan, the budget was about $14 billion. In 2003, after we sent large forces into Iraq, the budget jumped to about $88 billion. In its most recent request, if you add together what's already been provided by Congress in 2007 with the new request, it would amount to about $163 billion. That is roughly a doubling of GWOT costs in just the past 4 years.

The second point I would like to make is that it is unclear why the GWOT has proven to be so expensive and why there has been such significant cost growth in recent years.

Chairman CONRAD. Mr. Kosiak, when you refer to GWOT, just for those who are listening, you are referring, I assume, to the global war on terror?

Mr. KOSIAK. Yes, yes.

Chairman CONRAD. That is kind of the shorthand here in Washington, but those who are listening in might not be able to translate that.

Mr. KOSIAK. Good point.

If you look at the estimates of the cost of conducting military operations in Iraq and Afghanistan, those have grow significantly over time, and this is true even if you adjust for changes in force structure, and in force levels that have occurred.

In September 2002, CBO estimated that based on the cost of past conflicts like Desert Storm/Desert Shield and operations in Bosnia and Kosovo, sustaining an occupation force consisting of 75,000 to 200,000 United States troops in Iraq would cost something like $20 to $50 billion a year. And that works out to about $250,000 per troop.

CBO's high-end estimate of the number of troops required turned out to be fairly close to the mark, but its per troop cost estimate turned out to be far too low.

In 2004, CBO released another estimate. In this case, the costs per troop work out to something like $320,000 per troop. In its most recent 2006 estimate, CBO increased its estimate of funding for the global war on terror once more. This time the costs per troop work out to something like $540,000 per troop.

This is more than twice what CBO estimated in 2002 prior to the war in Iraq, and nearly 30 percent higher than what they were projecting just a few years ago in 2005.

If this cost growth in CBO's analysis were based on data they had gotten from DOD, rigorous detailed cost data, then this cost growth might not be so troubling. But that is not really what it is based on. CBO's latest estimate is basically a simple extrapolation of enacted appropriations from 2006 adjusted for inflation and changes in force levels. It is not a truly independent estimate of the cost of military operations in Iraq or Afghanistan or other activities related to the global war on terror.

This cost growth might also be less troubling if it were clearly linked to changes in OPTEMPO or changes in the amount of equipment that needs to be replaced and repaired, or the inclusion of costs related to training and equipping Iraq and Afghan security forces. But even taking these factors into account, much of the growth I have described is left basically unexplained.

I want to make clear that nothing I am saying here should be taken as a criticism of the Congressional Budget Office. The problem is that CBO has not been provided with the kind of data it needs to do these kinds of estimates, either to do independent estimates of GWOT costs or to verify the accuracy of DOD's estimates of GWOT costs, as well as funding requirements.

It has also made it very difficult to project future funding requirements with any level of confidence. This is a point that CBO has made on multiple occasions over the past year and going back at least, I think, as far as 2004.

The third point I would like to make is that an increasing share of funding for the global war on terror appears to be going to programs and activities that are, at best, only indirectly related to the military operations in Iraq or Afghanistan. This may be part of the explanation for this cost growth that we have seen in recent years. There has always had some funding in these supplementals that has been unrelated or only loosely related to the wars in Iraq and Afghanistan. The most obvious example of that is funding for the Army's modularity program. But it is unclear just how much money funding in these past supplementals was in this category.

Whatever has been true in the past though, it seems likely that in the future more of this kind of funding is going to be included in the GWOT, in the global war on terror appropriations. In part, this is because in October of 2006, Deputy Secretary of Defense Gordon England sent the services a new guidance, telling them that they should not feel that they have to limit their requests for supplemental funding for the global war on terror to programs and activities closely related to the operations in Iraq and Afghanistan, but should feel free to include, with a few caveats, funding for a broad range of other programs and activities that fit within the broader global war on terror.

Unfortunately, in my view, this basically removed any principal distinction for the services between what they should include in base budgets, long-term budgets, and what they should include in special global war on terror appropriations.

The most significant problem with this approach is that this guidance basically tells the services that they do not need to find room in their regular baseline budgets for fully covering the costs of their long-term force structure readiness and modernization plans. The services already have a serious and persistent problem in coming up with and presenting long-term plans that actually fit within realistic projections of what level of funding is going to be available. This change will only make the matter worse and, in the end, the services will have inevitably suffered the most from this weakening of their planning and budgeting process.

The fourth and final point I want to make is just that we really do need to improve our understanding of these costs. If we are going to appropriately and effectively budget for the global war on terror in the future and if we are going to appropriately budget for the service's long-term force readiness and modernization plans. It is not just a question of getting the global war on terror right, it is getting their long-term plans right.

CBO has done the best that they can do with the data available, but that data has not been very good. And I think CBO could do a much better job, and other analysts could do a much better job, if the Department of Defense would provide more rigorous data, and more detailed and more timely data.

At present, at this point I cannot say whether that data has been provided in the most recent budget request or whether it will be provided in the coming weeks. But if it is not provided, then I think Congress needs to once again pressure the Administration to provide better data.

With that, I will end my comments and again, thank the committee for inviting me here this morning.

[The prepared statement of Mr. Kosiak follows:]

The Global War on Terror (GWOT): Costs, Cost Growth and Estimating Funding Requirements

Testimony Before the

United States Senate

Committee on the Budget

Steven M. Kosiak

Vice President for Budget Studies
Center for Strategic and Budgetary Assessments

February 6, 2007

Mr. Chairman and members of the committee, it is an honor to appear before you today to discuss some of the issues surrounding the budgetary costs of the so-called Global War on Terror (GWOT). With over 3,000 American service members killed in the wars in Iraq and Afghanistan, and some 25,000 wounded, the financial costs of the GWOT is, understandably, of secondary interest and importance to most Americans. That said, with the total amount of GWOT funding provided over the past seven fiscal years now totaling some $502 billion, and the administration requesting another $93 billion in GWOT funding for fiscal year (FY) 2007 and $142 billion for FY 2008, Congress has a responsibly to closely examine the budgetary aspects of the GWOT.

In my testimony today, I have chosen to focus on four areas related to GWOT costs and funding requirements. Briefly stated, the main points of my testimony can be summarized as follows:

- The GWOT has proven very costly in budgetary terms, and those costs have grown dramatically over time.
- It is unclear why the GWOT has proven so costly, and why its costs have grown so significantly in recent years.
- An increasing share of GWOT funding appears to be for programs and activities largely unrelated to the military operations in Iraq or Afghanistan.
- We need to improve our understanding of GWOT costs significantly if we are to budget appropriately and effectively for the wars in Iraq and Afghanistan, as well as the Services' baseline force structure, modernization and readiness plans, in FY 2007, FY 2008 and future years.

I will spend the remainder of my time explaining and discussing these four points.

1) The GWOT has proven very costly in budgetary terms, and those costs have grown dramatically over time

Since fiscal year (FY) 2001, Congress has appropriated about $502 billion for the GWOT. This includes some $463 billion for the Department of Defense (DoD) and $39 billion for other departments and agencies.[1] Military operations, reconstruction and other assistance to Iraq and Afghanistan account for, respectively, some $345-375 billion and $100 billion of this total.[2] The remaining roughly $25-55 billion has been used to fund a

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[1] These totals include $70 billion provided in the FY 2007 defense appropriations act and $432 billion provided in earlier years. CBO, "Estimated Appropriations Provided for Iraq and the War on Terrorism, 2001-2006," pp. 1-4.

[2] Author's estimate based on DoD, Congressional Research (CRS) and CBO data. The range cited for Iraq costs primarily reflects differences in how CRS and CBO attribute GWOT costs. See, Amy Belasco, "The Costs of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11,"April 24, 2006, p. 10; CBO, Ibid , p.1.

variety of other programs and activities, including classified programs, Army and Marine Corps restructuring and some homeland security activities (Operation Noble Eagle).

Yesterday, the administration requested another $93 billion, in an FY 2007 supplemental appropriation, for the GWOT. It also requested $142 billion to cover GWOT costs in FY 2008. If these two measures are enacted, total GWOT funding would reach some $737 billion through the end of next year. This would make the GWOT more expensive than either the Korean ($460 billion) or Vietnam ($650 billion) Wars.[3]

Notwithstanding the high cost of current military operations, spending on defense today accounts for a significantly smaller share of gross domestic product (GDP) than it did during either of these past wars. At the height of the Korean (1953) and Vietnam (1968) Wars, total spending on defense (including both war-related spending and funding for DoD's "peacetime" force structure, modernization and readiness requirements) absorbed about 14.2 percent and 9.4 percent, respectively, of GDP. By comparison, total spending on defense (again, including both war-related and other programs and activities) is likely to absorb some 4.5 percent of GDP this year.

On the other hand, the United States now faces severe budgetary challenges driven by looming demographic changes (the retirement of the baby boomer generation and associated increases in Social Security and healthcare spending) that it did not face in the 1950s and 1960s. In addition, the cost estimates for the GWOT cited above may substantially understate the costs associated with current military operations. Some analysis suggests that including Veterans Administration (VA) spending on medical care and disability, for example, could significantly, even dramatically, increase those costs.[4] Some have also argued that, since the GWOT has been paid for essentially by increasing deficit spending, rather than by making offsetting cuts in other federal programs or increasing taxes, a share of debt service costs should also be attributed to the GWOT. Including the 10-year interest payments associated with GWOT funding through 2006 alone could add some $250 billion or more to its costs.

The trend in GWOT funding has been steeply upward since 2001. Annual GWOT funding grew from about $14 billion in FY 2001, when US military operations in Afghanistan began, to $88 billion in FY 2003, when the United States invaded Iraq. By 2006, the annual GWOT budget had reached $120 billion. Congress provided $70 billion for the GWOT in its "bridge" fund attached to the FY 2007 defense appropriations act. If Congress approves the administration's new $93 billion supplemental request, total FY

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[3] Stephen Daggett and Nina Serafino, "Costs of Major US Wars and Recent US Overseas Military Operations," October 3, 2001, p.2. These figures have been converted into FY 2007 dollars.

[4] Estimates of the potential impact of the GWOT on VA costs vary substantially. Linda Blimes has estimated that providing disability compensation and medical care to veterans from Iraq and Afghanistan over the course of their lives will cost $350-700 billion. Linda Blimes, "Soldiers Returning from Iraq and Afghanistan: The Long-Term Costs of Providing Veterans Medical Care and Disability Benefits," paper prepared for the Allied Social Sciences Association Meeting, January 2007. On the other hand, CBO has estimated that the cost to the VA of providing veterans and their families assistance as a result of Operation Iraqi Freedom has amounted to a total of about $1 billion through the end of FY 2006. CBO, "Estimated Costs to US Operations in Iraq Under Two Specified Scenarios," July 13, 2006, p. 9.

2007 funding for the GWOT would reach $163 billion. This would be $43 billion above the level appropriated for FY 2006 and $82 billion more than was provided for FY 2005—amounting to roughly a doubling of GWOT appropriations in just two years.

It is impossible to project future GWOT funding levels with much confidence for two reasons. First, there is great uncertainty concerning how long and in what strength US forces will remain deployed in Iraq and Afghanistan in coming years. Second, as I will discuss shortly, it is unclear what is responsible for much of the cost growth in GWOT programs and activities that has occurred over the past few years. However, if the US military remains in Iraq and Afghanistan at current levels, it seems likely that annual funding for the GWOT will remain in the roughly $120-$160 billion range.

2) It is unclear why the GWOT has proven so costly, and why its costs have grown so significantly in recent years

Estimates of the cost of conducting military operations in Iraq and Afghanistan, and other activities related to the GWOT, have grown substantially and consistently over the past several years. This is true even adjusting for the changes in force levels (i.e., on a cost per troop/year basis). In September 2002, CBO estimated that—based on the costs incurred in the Balkans, Afghanistan and Desert Shield/Desert Storm—sustaining an occupation force consisting of 75,000-200,000 US troops in Iraq would cost some $19-50 billion (2007 dollars) a year.[5] This equates to average cost of about $250,000 per troop/year.[6] CBO's high-end estimate turned out to be fairly close to the mark in terms of the number of troops deployed in and around Iraq after the invasion in the spring of 2003. However, the costs per troop have turned out to be much higher than CBO anticipated based on the cost of past military operations.

In 2004, CBO released another estimate.[7] This estimate projected the incremental cost of sustaining all US forces engaged in the GWOT, including not only US forces in Iraq, but those in Afghanistan and personnel assigned to Operation Noble Eagle. This new estimate equated to costs per troop/year of some $320,000 (2007 dollars).[8] Part of the reason for this higher cost per troop/year is that CBO's new cost estimate included some funding for classified programs, as well as support to other countries ("coalition support"). According to CBO, its new, higher estimate also resulted from a refinement and reevaluation of its methodology for estimating war costs. At the time, CBO noted that, even with these refinements, its methodology appeared to produce estimates that

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[5] CBO, "Estimated Costs of a Potential Conflict with Iraq," September 2002, p. 5 All CBO cost estimates cited in this analysis have been converted to FY 2007 dollars.
[6] CBO does not, in its own analysis, cite cost per troop/year. This estimate was derived by CSBA by dividing the total cost estimate provided by CBO by the number troops assumed to be deployed (also specified in CBO's analysis). Cost per troop/year provides a convenient metric for measuring cost growth since, by definition, it is adjusted for changes in force levels.
[7] CBO, "Estimated Costs of Continuing Operations in Iraq and Other Operations of the Global War on Terrorism," June 25, 2004.
[8] Author's estimate based on Tables 3 and 4. Ibid

were some 12 percent below those that would be derived by simply extrapolating from DoD's expected obligations from 2004 appropriations.[9]

CBO also indicated that it was unlikely that this difference was attributable to increases in the pace of military operations (operational tempo, or OPTEMPO) caused by the worsening security situation in Iraq. It pointed out that most of the costs incurred in overseas military operations are associated with personnel, base support and other factors that are not usually correlated with OPTEMPO. Indeed, CBO noted that, based on DoD reports, costs driven by OPTEMPO appear to account for only about 10 percent of the total costs associated with the war in Iraq and other GWOT operations.[10]

In 2005, CBO again increased its estimate of GWOT costs.[11] This time, its cost estimate equated to costs per troop/year of about $450,000 (2007 dollars). However, unlike CBO's 2004 revision of its earlier cost estimates, this change does not appear to have resulted, at least primarily, from a refinement of its methodology. The new estimate made use of a new CBO methodology to estimate the costs of equipment repair and replacement requirements. But for all military personnel and other operations and support (O&S) activities (representing the bulk of the costs associated with military operations), CBO based its estimate, not on an independent "bottom-up" assessment, but on a simple extrapolation of obligations data reported by DoD in 2004, adjusted to take into account inflation and changes in personnel levels.

In 2006, CBO increased its estimate of GWOT costs once more.[12] This time, the costs per troop/year work out to some $540,000 (2007 dollars). This is more than twice as much as CBO projected in 2002, based on the cost of recent past wars, and nearly 30 percent more than its estimate from 2005. In this case, the entire estimate (including even those costs associated with equipment repair and replacement) is apparently based on an extrapolation of enacted appropriations from FY 2006, adjusted for inflation and changes in force levels.[13] In other words, in this most recent estimate, CBO did not derive an independent estimate of the cost of military operations in Iraq or Afghanistan, or any other activities associated with the GWOT.

Part of this cost growth appears to be due to the inclusion of funding for training and equipping Iraqi and Afghan security forces within the DoD budget beginning in FY 2005 (previously funding for these activities had been provided through the international affairs budget). Another reason for this cost growth is the inclusion of an increasing amount of funding related to so-called "reset" costs. But these two factors still leave much of the cost growth unexplained. Excluding all funding for indigenous security forces and for repairing and replacing equipment from CBO's most recent estimate

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[9] Ibid., p. 8.
[10] Ibid., p. 9.
[11] CBO, "An Alternative Budget Path Assuming Continued Spending for Military Operations in Iraq and Afghanistan and in Support of the Global War on Terrorism," February 2005.
[12] CBO, "Additional Information About the Alternative Spending Path for Military Operations in Iraq and Afghanistan and for the War on Terrorism," September 22, 2006.
[13] Ibid., p. 2.

suggests cost per troop/year of some $400,000 (2007 dollars).[14] This is well above the costs per troop/year implicit in CBO's initial, independent estimates of GWOT costs.

Nothing in the above discussion should be taken as a criticism of CBO. The problem is that CBO is not provided by DoD with the kind of data it needs to generate its own independent estimates of GWOT costs, or to verify the accuracy of DoD's estimates of those costs. CBO has testified several times over the past year concerning cost-estimating difficulties, the need for better and more timely data, and other issues related to budgeting for the GWOT.[15] However, as early as 2004, CBO made clear the serious nature of its concerns about the GWOT data DoD was providing:

> Obligations for Operations Iraqi Freedom and the other GWOT operations vary widely from month to month, making it difficult to discern trends. Those data provide no information about the pace of operations or the force levels underpinning those costs, nor do they segregate one-time costs from recurring or day-to-day costs. Some obligations are recorded months after the actual activity occurred because of the time needed to establish proper billing and reimbursement. Without more detailed information, it is difficult, if not impossible, to use the reported obligations to estimate future costs.[16]

In turn, these serious data limitations prevent CBO and others from evaluating the reasonableness of DoD's requests for GWOT funding as effectively as would otherwise be possible. It also makes it impossible to confidently project future GWOT funding requirements, even assuming agreement on the number of troops likely to be deployed in Iraq and Afghanistan.

3) An increasing share of GWOT funding appears to be for programs and activities largely unrelated to the military operations in Iraq or Afghanistan

Part of the explanation for the growth in GWOT costs and funding discussed above may be that, increasingly, funding for programs and activities unrelated (or at least not closely related) to the military operations in Iraq and Afghanistan appears to be included in GWOT appropriations. The administration's GWOT supplemental requests have always included some funding for such programs. The clearest illustration of this practice is the inclusion of funding for the Army's modularity program in the FY 2005 and FY 2006 supplementals. According to Army officials, the Service would be restructuring its forces even if they were no longer engaged in operations in Iraq or Afghanistan, since they believe it is needed to improve the capability of the Army to fight effectively in future conflicts.

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[14] Author's estimate.
[15] See, for example, Robert A. Sunshine, "Issues in Budgeting for Operations in Iraq and the War on Terrorism," testimony before the Committee on the Budget, US House of Representatives, January 18, 2007
[16] CBO, "Estimated Cost of Continuing Operations in Iraq aud Other Operations of the Global War on Terrorism," p. 7.

Because of the severe data limitations discussed earlier, it is unclear just how much of the funding in past GWOT appropriations has been unrelated to conducting the military operations in Iraq and Afghanistan. However, it seems likely that the amount of funding included in GWOT appropriations requests for such programs and activities will increase this year, and in future years.

In October 2006, Deputy Secretary of Defense Gordon England sent the Services new guidance to use in drawing up their respective requests to the Office of the Secretary of Defense (OSD) for 2007 supplemental funding. The most important element of this brief memo was the following instruction:

> By this memo, the ground rules for the FY'07 Spring Supplemental are being expanded to include the [Defense] Department's efforts related to the Global War on Terror and not strictly limited to Operation Enduring Freedom (OEF) and Operation Iraqi Freedom (OIF).

With this guidance, the Defense Department essentially opened the floodgates in terms of what the Services could ask to have funded through GWOT supplementals. In the administration's eyes, the GWOT or Long War, as it is referred to in the 2006 Quadrennial Defense Review (QDR), represents a broad framework for organizing the US military's strategy, planning, programming and budgeting over the coming decades. It is similar to how the concept of containing the Soviet Union was used to provide such a framework during the second half of the 20^{th} century.

Whether or not such a broad conceptualization is, in general, the most useful way to view the GWOT is debatable. But, whatever the merits of this nomenclature, a serious problem is created when such a broad definition of the GWOT is used and the Services are then told that virtually anything related to the GWOT can be funded through special GWOT appropriations. And this is true whether the special appropriations consist of supplementals or special war-related accounts attached to the regular annual defense appropriations act. In either case, the Defense Department has basically removed any principled distinction between what should be included in special GWOT appropriations and what should be included in the rest of the defense budget.

It is roughly equivalent to telling the Services in 1968, at the height of the Vietnam War, that their requests for Vietnam War funding can include basically anything related to winning the Cold War competition with the Soviet Union. The most significant problem with this approach is that such guidance amounts to, in effect, telling the Services that they no longer need to find room in the regular annual defense budget to cover the full cost of their long-term plans.

The Services already have a perennial problem with developing and presenting long-term readiness, force structure and modernization plans that are actually affordable within projected or likely funding levels. In October 2006, CBO estimated that unless the peacetime defense budget—i.e., the defense budget exclusive of funding for military operations—is increased well above current levels and even the (higher) levels projected for 2011 under the administration's current plan, the gap between available funding and the cost of implementing the Defense Department's long-term plans could average as much as some $65 billion over the next two decades. Offering to the Services the option of shifting some of these funding requirements into special appropriations, which heretofore have been, at least largely, limited to covering the cost of military operations, will only further diminish the realism of their long-term planning and budgeting.

Moreover, in the end, the Services will inevitably suffer the most from this weakening of their planning and budgeting process. At some point, the wars in Iraq and Afghanistan will wind down. And when that happens, the Services may well find the special GWOT appropriations drying up, and their baseline budgets—after years of relying on these special measures to cover a portion of their costs—well below the level of funding needed to actually carry out their long-term plans.

4) We need to improve our understanding of GWOT costs significantly if we are to appropriately and effectively budget for the wars in Iraq and Afghanistan, as well as the Services' baseline force structure, modernization and readiness plans, in FY 2007, FY 2008 and future years

As discussed at the outset of this testimony, the Congress has already appropriated some $502 billion for the GWOT. Under the administration's recently announced plans, total GWOT funding would reach $737 billion by the end of FY 2008. Based on the most recent funding requests, it is reasonable to conclude that—baring a significant reduction in the number of troops deployed in Afghanistan and, particularly, Iraq—annual GWOT funding is likely to amount to some $120-160 billion in the years beyond 2008.

Moreover, even assuming US military forces are largely withdrawn from Iraq over the next several years, future funding for the GWOT could amount to an additional hundreds of billions of dollars. Extrapolating from FY 2006 funding levels, adjusted for changes in the number of troops deployed, last September, CBO projected that if US forces in and around Iraq and Afghanistan could be reduced (from 2006 levels of about 220,000 troops) to 55,000 troops by 2011 and kept at that level through 2016, a total of $483 billion in GWOT funding would required over the FY 2007-16 period.[17] In other words, even assuming the number of US troops deployed in GWOT operations is drastically reduced over the next few years, the total amount of funding provided for the GWOT could reach nearly $1 trillion by FY 2016, even excluding interest payments and other indirect costs.

Given the magnitude of these expenditures, both past and future, Congress needs to have confidence that the cost and budget estimates it receives from DoD accurately reflect the costs incurred as a result of the GWOT. Unfortunately, as discussed in the second part of my testimony today, it is difficult, at present, to have such confidence.

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[17] CBO, "Additional Information About the Alternative Spending Path for Military Operations in Iraq and Afghanistan and for the War on Terrorism," p. 3.

Because of significant limitations in the budgetary and related operational data provided by DoD, CBO has been unable to provide Congress with a truly independent and fully effective review of the administration's funding requests for the GWOT, or reliable estimates of likely future costs under various possible scenarios.

CBO has done the best it can, given these serious data limitations, and has provided a wide variety of valuable budget and cost estimates related to the GWOT. But with improved data it might be able to provide significantly better analysis and oversight related to GWOT costs and funding requirements. Both Congress and CBO have made clear to DoD the importance of receiving sueh data. Hopefully, DoD will include improved data in its budget justification materials beginning this year. It has indicated that it will provide timely and detailed justification materials concerning both the FY 2007 supplemental request and the FY 2008 request for GWOT funding. At present it is too early to tell whether these materials will in fact include the kind of data CBO and others would need to effectively analyze and evaluate DoD's requests effectively. If it does not, Congress will need, once again, to pressure the administration to provide this data.

Congress should also make clear to the administration that DoD should, except perhaps in exceptional circumstances, limit its requests in GWOT appropriations to funding for programs and activities directly related to the military operations in Iraq and Afghanistan. The administration's inclusion, for the first time, of GWOT funding for the coming fiscal year in its FY 2008 request is a positive, if long overdue, step. Assuming the request is accompanied with appropriate and timely justification materials, this should enhance Congress' ability to conduct effective oversight. However, as discussed in the third part of my testimony today, the inclusion of substantial amounts of funding for programs and activities unrelated to the military operations in Iraq and Afghanistan in GWOT appropriations—whether in the form of supplementals or separate accounts attached to the regular annual appropriations act—is likely to weaken DoD's long-term planning and budgeting process, ultimately to detriment of the department.

Chairman CONRAD. Thank you for your testimony. Now we will turn to Dr. Gordon Adams, a Fellow at the Woodrow Wilson International Center for Scholars and a former Associate Director of the Office of Management and Budget for National Security.

Welcome, Dr. Adams.

STATEMENT OF GORDON ADAMS, FELLOW, WOODROW WILSON INTERNATIONAL CENTER FOR SCHOLARS

Mr. ADAMS. Thank you, Mr. Chairman and ranking member. Thank you for holding this hearing.

I think it is a very timely and important matter you are dealing with here today and it is not going to stop here. It is a matter that you are going to have to deal with, sadly, for sometime to come.

I also want to commend both you Mr. Chairman, and the ranking member, for stepping up to this issue over the past year, addressing yourselves directly to the Department of Defense and the Administration and urging legislating the expectation that budget expenditures for the global war on terror, and Iraq will be brought forth as part of the regular budget. I will make a comment about that in a moment in terms of the current budget request.

I want to talk about a couple of areas this morning, but let me start by saying that spending on the global war on terror, roughly 80 percent of which is for the conflict in Iraq, is consuming a rapidly rising share of defense spending and of the overall budget. If you take all of the requests for the global war on terror together, over the next 18 months we will be increasing spending for the global war on terror by 50 percent over all prior spending for the global war on terror. So it is a very rapid slope upwards.

I want to talk about two areas briefly this morning. One of them concerns defense programs and it will reinforce some of the points that Steve Kosiak has just made, about the integrity of the defense budget process and the quality of the justification for this spending. And I want to mention briefly the budget implications of the Administration's proposal to expand the size of United States ground forces overall for the long war on terrorism.

The second area I want to mention, which we do not talk so much about, is international affairs spending which is also, a concern of this committee. I want to talk a bit about the adequacy of our estimating and budgeting for Iraqi security assistance and economic reconstruction, and about the issue of the relationship between Defense and the State Department and AID with respect to the delivery of these kinds of programs.

First off, defense. As Steve Kosiak has said, this war is getting increasingly expensive and it is, as the Chairman has said, being funded largely through emergency supplemental or bridge funding.

What is interesting is if you go back and look at the overall share of total resources available to the Department of Defense over the last eight budget years, there has been a very sharp increase in the share of the total resources coming through emergency and bridge funding supplementals. That share has risen from something like 6 percent in fiscal year 2001 to 21 percent in 2006 to, if you accept the President's current request, 27 percent in 2007, and 23 percent in 2008, with more likely on the way.

In other words, about a quarter of the total resources available to the Department of Defense right now are coming through these emergency supplementals and bridge funding for the global war on terror.

What this has meant, in effect, is that the Defense Department has been conducting two parallel budget processes. One process that is, the PPBES, the normal programming planning, programming budgeting and execution system. And the other is the emergency supplemental and emergency bridge funding requests.

These latter are out of phase with the normal budget cycle in the Department of Defense and tend to be given much less scrutiny of the kind that is given to the normal budget in the PPBES system.

The Administration has decided it will comply with the language of Section 1008 of the Authorization Act and send up with its fiscal 2008 budget the fiscal 2008 request it has in mind for the global war on terror. That is a good thing and I commend them for taking that step. I think Director Portman deserves a lot of credit for pushing that very hard.

On the other hand, this spending was still prepared outside the normal budget process in the Department of Defense. The guidance for the FY 2007 supplemental and the guidance for FY 2008 both came out long after the PPBES system had been dealing with scrutiny of the Defense Department's regular budget. So it still does not get the same kind of scrutiny.

That dual process has had a corrupting effect on the normal Pentagon PPBES system, because the Department tends to treat these two budgets as fungible. Steve Kosiak has talked about programs that show up in the emergency supplementals that are really longer-term, such as long-term delivery of aircraft, helicopters, and long-term planning for forces. But they show up in the emergency supplemental request.

Operations and maintenance funding, in general, is fungible between the resources provided for the war and the resources provided for the normal operations of the Department of Defense, outside the conduct of the global war on terror.

So, to reinforce the points that both of you have made, there needs to be a clearer separation between the two. Gordon England's guidance to the services to prepare the FY 2007 second supplemental muddied the waters even further by allowing items related to the long war to be included in the emergency supplemental.

Let me address my second point briefly, and that is the expansion of the Army and the Marine Corps, which is also included in the President's budget. This is relatively unrelated to Iraq, maybe even to Afghanistan, because troops that are needed under that process are likely not to be available in time to solve the stressful rotation problems there.

But here, too, there is a budgetary problem. Aside from the question of whether such an expansion is justified, which I have written about in other contexts, the emergency supplemental for FY 2007 includes $1.2 billion for this force expansion. So it is put on an emergency basis, though it is not an emergency program. In timing terms, this may get it going but, it is in the wrong place in the budget. There is $12 billion in the 2008 budget for this process.

As a budgetary matter this force expansion has grave implications for the defense budget and for the overall Federal budget and for your work. Forces in the end drive budgets. This will be an expensive proposition. Press reports now say that it will cost as much as $117 billion and it may lay $15 to $20 billion a year against each annual budget to accommodate the future costs.

Forces drive defuse budgets, and we have had a "consumption driven" buildup over the past 6 years that will further drive the defuse budget. We will have a lot of people who will require a lot of training, who will require a lot of equipment.

This is a problem if defense budgets turn around and start to come down because there will need to be bill payers. And some of that bill paying may happen inside the defense budget itself. That will have a potentially dramatic impact on the acquisition of technology and new equipment in the services as procurement budgets become the bill payer for expanded force size.

And it may, as well, be a problem for the Federal budget as a whole. In the President's budget, submitted yesterday, something like 56.2 percent of all discretionary spending, was committed to what is called "security spending". A useful concept actually, defense, homeland security throughout the Government, and Function 150 (international affairs). By 2008, that security share would rise to 60 percent, and it would be 65 percent if one fully included the costs of the global war on terror.

In other words, about two-thirds of Federal discretionary spending by 2008 would be committed to security issues. And the Administration has been quite up front about the priority that they put on those expenditures. That is likely to make your job considerably difficult, year by year, as those programs consume larger and larger shares of discretionary spending.

Finally, let me turn to the two implications, I want to mention for the international affairs account. We do not talk about it much and yet arguably the critical contribution that diplomacy and foreign assistance make to our national security obligates us to focus on those tools of statecraft that reinforce, supplement, may even make unnecessary certain military operations.

In the global war on terror related budgets, there are $6.3 billion worth of global war on terror-related nondefense programs in the 2007 emergency supplemental and another $3.5 billion in the fiscal year 2008 emergency part of the budget. And of this, 95 percent is in international affairs.

I want to make two points about this. Point No. 1: we are not doing a very good job of estimating the fiscal needs involved here. As the Special Inspector General for Iraq Reconstruction has pointed out in his latest quarterly report, the United States has comitted over $38 billion to security assistance and foreign assistance in Iraq since the war began.

That understates, however, the level of the resources committed to these purposes. Over $50 billion of Iraqi government funds, some seized funds, some budgeted over the past 2 years, have gone to the same purpose. And there is $15 billion worth of international funds coming in quite slowly, that have been committed, for this purpose.

Put another way, the total commitments and expenditures on Iraqi reconstruction and security assistance since the war began come to over $100 billion. Not $20 billion, not $38 billion, but over $100 billion.

We have not done a very good job of estimating that cost. Even the international community has not done a very good job, since the 2003 World Bank/UN estimate of the costs of reconstruction in

Iraq was $55 billion, or just a little over half of what has been comitted.

There is another $18 billion worth of security assistance and economic reconstruction assistance in the 2008 budget request. So that cost is going up.

Senator DOMENICI. Mr. Chairman, might he go back 2 minutes and repeat what he has just said?

Mr. ADAMS. I am happy to, Senator. Where do you want me to pick up?

Senator DOMENICI. Do you know where you talked about this last set of estimates being out of—

Mr. ADAMS. The reconstruction and security assistance estimates.

Senator DOMENICI. It is much bigger, and I did not understand what that was.

Mr. ADAMS. Absolutely. The Special Inspector General for Iraq Reconstruction, Stuart Bowen, estimated in his last quarterly report, that the United States has committed over $38 billion to security assistance and economic reconstruction assistance in Iraq.

Iraqi government funds have amounted to over $50 billion. Some of it is funding that we retained control over because it was seized in oil-for-food assets. Some are assets they have budgeted through their own capital budget for economic reconstruction.

And third, there is about $15 billion worth of international community—World Bank, International Monetary Fund, European Union, Japan, Britain and other countries—commitment to Iraqi reconstruction.

The total is $104 billion. That is setting aside the $18 billion requested for fiscal year 2008 in the President's budget, which would be in addition.

Is that clear?

Senator DOMENICI. Thank you, Mr. Chairman.

Mr. ADAMS. Finally, the last question I want to deal with, Mr. Chairman, is the question of responsibilities for these programs. Iraq and Afghanistan have been a test bed for a different way of delivering foreign and security assistance by the United States Government. It is a test bed for a concept that has the Defense Department increasingly assuming responsibilities for security assistance and foreign assistance delivery. This includes a major training and equipping program in Iraq and Afghanistan, not dissimilar to what we might have done under foreign military financing, but we are now doing directly through Department of Defense funding.

They are seeking to globalize that training and equipping program in order to stabilize and restore authority to ungoverned areas and prevent terrorist havens elsewhere.

Second, the Commander's Emergency Response Program, (CERP), has become a billion-dollar item in the fiscal 2008 budget request. It is for local rapid delivery of what is, in effect, economic and reconstruction assistance. The Pentagon seeks to globalize that program, as well.

And two new fellowship programs, a counterterrorism fellowship program and a stability operations fellowship program, both of which are operated independently of the International Military Education and Training Program, (IMET). And budgetary support, because through Pentagon funding and emergencies we are, in effect, reimbursing the Pakistani government and other governments for their support with the global war on terror.

The argument is that the Defense Department itself has the skills, the logistics, the equipment, the budget, the direct contacts to do this in an effective and efficient and agile way and the State Department and AID do not. They lack the budget, cannot raise it, do not have the training, do not focus on these issues.

As a consequence, we are walking down a road without really evaluating where we are going. The consequence for the State Department is that as we charge Defense more and more with foreign and security assistance responsibilities, we begin to disempower the State Department and AID to oversee policy and to supervise and implement such programs.

And the consequences for the Defense Department are that we increasingly are putting our men and women in uniform into the job of security and foreign assistance providers, which diverts them from their core military mission.

In effect, we may be underfunding and disempowering our diplomacy and foreign assistance, and, at the same time, distracting the military from their core mission.

So I urge you, when you talk with other witnesses both from the State Department and AID, and from the Defense Department, that you raise these issues about the balance and integration of our security assistance and foreign assistance efforts.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Adams follows:]

Budgeting for Iraq and the GWOT

Testimony

Committee on the Budget
United States Senate

Dr. Gordon Adams

Fellow

Woodrow Wilson International Center for Scholars

February 6, 2007

I am grateful to the Chairman and the Ranking Member of the Committee for inviting me to testify today on the critical and timely question of how we are paying for continuing military operations in Iraq, as well as Afghanistan, and elsewhere for what is called the Global War on Terror (GWOT).

This hearing is especially timely, given the arrival yesterday of the administration's proposed budget for FY 2008, which includes proposed emergency funding for the GWOT, and which is accompanied by the second emergency supplemental budget request for the GWOT in FY 2007.

Spending for the GWOT, roughly 80% of which is for the conflict in Iraq, is consuming a rapidly rising share of defense spending and of the overall budget. Including the second FY 2007 supplemental request, the budget transmitted to the Congress yesterday seeks $245 b. for the GWOT, most of it for operations in Iraq. There is every possibility of a second emergency supplemental request later in FY 2008.[1] Since FY 2001, the United States has already committed over $500 b. to this effort.[2] The new request would increase total spending for the GWOT by nearly 50% over all previous spending on these operations.

Were the Congress to approve all the requested funds, the overall defense budget would rise, correspondingly, to $623 b. in FY 2008, an unprecedented level since the Vietnam War. While some will argue that defense spending remains low and inadequate for long-term defense needs, if we cannot provide military security for the United States at this level of spending there is something seriously wrong with planning and implementation in the Department of Defense.[3]

I want to address two areas this morning. The first concerns defense programs, the impact of using emergency supplemental and bridge funds on the integrity of the defense budget process, the quality of the justification provided for this funding, and the implications of the administration's proposal to expand U.S. ground forces to deal with the requirements of what they call the "long war" against terrorism.

The second area concerns the other, smaller part of GWOT funding – the international affairs budget, to which we often pay less attention. I want to discuss the adequacy of our budgeting for security and economic assistance related to the GWOT, and rising concern about the degree to which increased DOD programs and funding in this area may be distorting the tools of American statecraft.

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[1] The President's FY 2008 budget document notes: "As activity on the ground evolves, the administration may adjust the requested amount or its allocation through a budget amendment or subsequent supplemental request."

[2] According to the Congressional Research Service, including the $70 b. "bridge fund" for FY 2007, operations in Iraq, Afghanistan, and globally against terrorist organizations have cost $507 b. More than 90% of this total is for defense activities. CRS, *The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11*, No.RL33110, September 22, 2007.

[3] The Congressional Budget Office has suggested that current "peacetime" defense budgets are inadequate to support defense plans by perhaps $65 b. over the next two decades.

I will discuss each of these issues briefly, and am happy to elaborate on them in response to questions you and the other members of the committee may wish to raise.

The Implications of GWOT Spending for Overall Defense Budgeting

For the past eight budgets, the Department of Defense has requested emergency supplemental or "bridge" funding for the GWOT, outside of the regular defense budget. I have calculated that these emergency funds constitute a rising share of the total resources available to the Defense Department. The "emergency" share of overall DOD resources has risen from just under six percent in fiscal year 2001, to over 21 percent in FY 2006.

If Congress appropriates the full request for the second FY 2007 emergency supplemental this share would rise for 27% for FY 2007; appropriating the FY 2008 request would put that share at at least 23%, with the Pentagon likely to seek more emergency funding next year. In other words, roughly 25% of all the resources available to the Department of Defense are now being provided through the emergency funding mechanism.[4]

The continuing use of emergency supplementals is not typical in wartime. In the cases of the Korean and Vietnam Wars, war budgets have relatively quickly been integrated into overall DOD budget planning, as they have become the major activity in which the services are engaged.[5] In the GWOT case, however, the Defense Department has, in effect, been running two parallel budget processes, one for the GWOT and the other for the regular defense budget. Continuing this practice over eight budgets has had a debilitating effect on the integrity of the defense planning and budget process in the Department of Defense.

Emergency and supplemental funding requests are not processed through the Planning, Programming, Budgeting, and Execution System (PPBES), the normal mechanism for peacetime or "regular" DOD budget planning. They are typically out of phase with the PPBES system. Deputy Secretary of Defense Gordon England provided guidance for the second FY 2007 supplemental in October, 2006, after funds had been appropriated for this year and well outside the PPBES scrub being done on the FY 2008 budget.

Members of this committee and the Armed Services committees have already expressed concern about this dual-track budget process. You have written to the Secretary of Defense urging that the Department comply with Section 1008 of the John Warner FY 2007 National Defense Authorization Act, requiring the administration to submit war costs simultaneously with the transmittal of the regular defense budget. After initially interpreting that provision as inconsistent with the President's authorities, the administration has now agreed to comply with the provision, and the new budget

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[4] My calculations were done using CRS data in their report referenced above. Cross-checking with the new DOD budget request, the percentages are slightly different, but consistent: 23.1%, 27.3% and 22.7%

[5] See Congressional Research Service, "Military Operations: Precedents for Funding Contingency Operations in Regular or in Supplemental Appropriations Bills," Short Report RS22455, Washington, DC: CRS, June 13, 2005

transmits an estimate of FY 2008 war costs, along with the regular defense budget, as an additional "emergency" request.

The administration is to be commended for complying with this provision, after all. That said, the war budget was put together outside the PPBS process, meaning it did not undergo quite the same "scrub" as the rest of the budget may have had. As a result, it is very important for this committee and the rest of the Congress to scrutinize the DOD justification materials for the GWOT request in detail.

This intense scrutiny is important because, in planning terms, DOD has tended to treat the two budgets as fungible. This is the source of the negative impact emergency supplemental funding has had on the integrity of the PPBES process. Given the urgent timing for supplementals and the reality that they receive less scrutiny, there has been a tendency in the Department to seek, through emergency supplemental funding, programs that do not meet the reasonable test for a war-related emergency: that the requested funds meet urgent requirements that could not be anticipated in the normal budget cycle.

In recent years, emergency funding has been sought for the acquisition of equipment that has long lead times, unrelated to the urgent demands of the war, such as aircraft, helicopters, and ground vehicles. Funding has been sought, as well, for force planning changes, such as Army modularity, which also have long lead times and are eminently manageable through the PPBES planning process.

There needs to be a clear separation between such funding requests and the funding for the war. Unfortunately, the Defense Department has encouraged such an overlap. In his guidance for the preparation of the FY 2007 second supplemental Deputy Secretary Gordon England explicitly noted that "the ground rules for the FY '07 Spring Supplemental are being expanded to include the Department's efforts related to the Global War on Terror and not strictly limited to Operation Enduring Freedom (OEF) and Operation Iraqi Freedom (OIF)."

It will, therefore, be very important for the Congress to examine the GWOT requests closely in order to separate out items that are not directly related to the war effort.

This will be especially important, given the administration's proposal to expand the size of our ground forces. I do not believe this ground force expansion has been adequately justified, as I have argued elsewhere. It is irrelevant to the stress the forces currently deployed in Iraq and Afghanistan are experiencing, which are painfully real. Expanded forces, which will be devilishly difficult to recruit, will not be ready for deployment in a time frame relevant to the current conflict.

More seriously, the Department has offered, at best, a thin justification for this expansion. Unless the nation is determined to engage in another Iraq-style invasion and occupation in the near future, it is hard to find a rationale for an expanded ground force. If the administration has the demands of the "long war" in mind, that mission requires small, agile, highly mobile forces of the kind we have in our Special Operations forces, not the heavier infantry and mobilized brigades being proposed for force expansion. It is my view that the Pentagon has put the force expansion horse ahead of the strategic planning cart.

As a budgetary matter, force expansion has significant implications for the concerns of this committee. First, this expansion would be expensive, easily $70-90 b. over the next ten years to recruit, pay, train and equip, with a permanent addition of at least $15-20 b. a year to the defense budget after that time. The FY 2007 supplemental includes $1.7 b. to support this end-strength increase and the DOD base budget for FY 2008 requests $12.1 b. for expansion.

Second, forces and end strength drive the rest of the defense budget (with the partial exception of research and development programs). Whether it involves new training, new equipment, or new construction, the upward pressure on the overall defense budget growing out of this expansion will have been built in permanently.

This pressure is likely to be particularly stressful for today's defense planning, as contrasted with previous periods of defense budget growth. There was considerably less pressure on overall budgets from the defense buildup of the 1980s, because it was "investment" driven. From 1980 to 1987, the procurement share of the defense budget rose from 22% to 30%. The forces that triumphed in combat in both Gulf Wars used the results of that investment surge to do so. The research and development share of the defense budget also rose over those years from 9.9% to 12.2%, pointing to the next generation of procurement.

The current defense budget growth, however, has been "consumption" driven. The procurement share of defense spending has remained at a lower level of 18%, with R&D rising from 14% to 15%. Operations and maintenance has been the focus of this buildup, driven largely by the war requirements. Army and Marine ground force expansion will add to the "consumption-driven" character of defense budget growth.

What are the implications of this difference? If, as seems likely, the U.S. eventually withdraws from Iraq, the defense budget will come down. If the Army and Marine size has grown, but the overall defense budget is in decline, there will need to be bill-payers to pay for the ground forces, their training and their equipment. The bill payers could well be the other services, with particularly harsh consequences for their long-term investments in new platforms and technologies.

There are also implications for the overall federal budget growing out of this force expansion. This committee will face a difficult set of tradeoffs between the continuing costs of a larger ground force and the priorities you may wish to give such areas as education and health. The new budget foreshadows this problem. According to the budget request, 56.2% of discretionary spending in FY 2006 was committed to what is called "security spending" (defense, Function 150, and government-wide homeland security). By FY 2008, the "security" share rises to nearly 60%. Continued upward pressure for these levels of security spending, driven largely by defense, will continue to put downward pressure on non-defense discretionary resources.[6]

I urge you to consider this broader issue of force expansion as you review the FY 2008 defense budget request.

The Implications for Diplomacy and Foreign Assistance

I also want to raise two issues with respect to the other part of our national security budget – Function 150 or International Affairs. In general, Congress has focused considerable attention in recent years on the defense spending committed to Iraq, but rather less attention to the smaller, but still considerable U.S. spending in foreign and security assistance in these countries, dedicated to training and equipping security forces and economic and social reconstruction and recovery.

It is my view that we typically tend to translate national security issues into "defense" issues, and tend to rely on the military tool of statecraft rather more than we do on our diplomatic and foreign assistance tools. Yet, given the critical contribution diplomacy and foreign assistance make to our national security, I think it important to focus on how these tools of statecraft and these fiscal resources are being used to meet our national security goals.

In the case of Iraq, while the US military plays an important role in near-term security for our operations and for the Iraq government, in the long-run U.S. diplomacy in that country and the region, and our security training and reconstruction assistance are likely to be the critical elements in restoring stability to that beleaguered country. The importance of diplomacy and assistance is underscored by the new budget request. By my calculations, there are $6.3 b. worth of GWOT-related, non-defense programs in the FY 2007 emergency supplemental request, and another $3.5 b. in the GWOT emergency budget for FY 2008, 95% of them in the international affairs budget function.[7]

There are two issues I want to raise for you in this area: first, the rapid and unanticipated growth in the fiscal requirement for Iraqi stabilization and reconstruction, with meager results on the ground and second, the growing Defense Department role and funding for programs that have, historically, been the responsibility of our other foreign affairs agencies.

First, as to the fiscal needs. The Special Inspector for Iraq Reconstruction has provided detail on US spending, which comes to nearly $38.3 b. since the war began.[8] This is larger than the $18.4 b. figure frequently used, which includes only the first large appropriation for Iraq reconstruction and the Coalition Provisional Authority in late 2003.

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[6] The "security share is even larger, rising to 65%, if one includes emergency supplemental resources appropriated or requested for FY 2006- FY 2008. Including appropriated and requested emergency funding for the GWOT, US government budgets for "security" would rise for the first time to over $1 trillion in FY 2007.

[7] The non-international affairs funding comes to roughly $300 m.

[8] Special Inspector General for Iraq Reconstruction, *Quarterly and Semiannual Report to the Congress*, January 30, 2007, p.115.

The more accurate, higher, total, includes all spigots of US foreign assistance to Iraq, including $26 b. of support for reconstruction (more than $5 b. of which has been spent on security for reconstruction activities) and the more than $12 b. in DOD-administered programs for local reconstruction activities (the CERP program) and the considerable effort to train and equip Iraqi security forces.

Focusing on U.S. appropriated funds, however, greatly understates the level of resources actually committed to Iraqi reconstruction. The total commitment of resources comes to nearly $104 b., much of which has been or is being spent. This is nearly twice the $55 b. estimate made by the World Bank/UN and the CPA in 2003.

Beyond the U.S. funds, the SIGIR notes that nearly $50.5 b. in Iraqi funds have been committed to reconstruction, beginning with our use of $25.7 b. in assets seized at the start of the war (captured funds, Iraqi accounts, and oil-for-food revenues). In addition, the government of Iraq has committed more than $24.7 b. in its capital budget to reconstruction. As others have noted, some of these Iraqi funds, probably growing out of the higher world price for oil, remain on deposit with the NY Federal Reserve, rather than being invested in Iraq.[9]

The international community has also made commitments, though these have been slower to deploy, coming to over $15.1 b., according to the SIGIR. Much of this is funding through the World Bank, International Monetary Fund, and United Nations, though the European Union, the United Kingdom, and Japan have also made considerable commitments.

To summarize, Iraqi reconstruction has already cost nearly twice what we once thought it would cost, and the results can be described, at best, as disappointing. As the SIGIR has put it:[10]

- Iraq's security forces developed more slowly than expected and the security environment has continued to deteriorate.
- Infrastructure security remains vulnerable.
- The capacity of Iraqi ministries to execute their capital budgets remains weak.
- The sustainability of completed IRRF projects remains a concern.
- Inconsistent coordination among the many U.S. agencies supporting Iraq's reconstruction has hampered the effective execution of the U.S. reconstruction program.

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[9] Karen DeYoung, "Doubts Run Deep on Reforms Crucial to Bush's Iraq Strategy," *Washington Post*, February 4, 2007, p.A16.
[10] *Quarterly Report*, pp.3-5

In its new budget requests for FY 2007 and FY 2008, the administration seeks something on the order of another $18 b. for training and equipping Iraqi and Afghani security forces, and emergency and long-term reconstruction assistance in the two countries. This committee will want to consider asking some hard questions about how programs will be changed to increase effectiveness, and whether they are executable, as planned, given the deteriorating security environment.

My second issue is about the long-term direction of U.S. security and foreign assistance policy, given the precedents being set in Iraq (and Afghanistan). The GWOT in those two countries has become a test bed for a new concept in U.S. foreign and security assistance. Increasingly, the Defense Department is expanding its role in this area, altering an historic practice of State Department (and AID) policy supervision (and implementation) for security and foreign assistance. The elements of this expansion are increasingly clear:

- The new emergency supplemental request for fiscal year 2007 includes significant funding – $3.8 b. for Iraq and $5.9 b. for Afghanistan (on top of the $3.2 b. already appropriated last fall) – to train and equip (T&E) the Iraqi and Afghani militaries. The FY 2008 GWOT emergency request seeks another $4.7 for these programs. This T&E program continues the practice since 2003 of funding such programs directly through the Defense Department, though the State Department has historically had policy lead on such programs as Foreign Military Funding and International Military Education and Training, and peacekeeping assistance to train militaries around the world for peacekeeping duties. The Iraq and Afghanistan T&E programs have already amounted to over $15 b.

- The Defense Department is seeking authority to "globalize" and make permanent its authority to conduct such programs in order to stabilize and restore authority to ungoverned areas and deprive terrorist organizations of potential safe havens. A temporarily authorized global program began in 2006 with a $200 m. funding ceiling for what are called Section 1206 programs, which rose to $300 m. by fiscal year 2007. DOD may be seeking to expand this ceiling and make this authority permanent in the new budget.

- DOD also intends to seek permanent authority for a global version of its foreign assistance, program - the "Commander's Emergency Response Program" (CERP). Through CERP, DOD has already spent nearly $2 b. in Iraq alone, outside the IRRF and other bilateral foreign assistance programs being delivered under State Department and USAID authorities. The FY 2007 emergency supplemental seeks another $456 m. in authority for the CERP in Iraq and Afghanistan, and the FY 2008 GWOT request would raise this ceiling to nearly $1 b.

- DOD also intends to propose funding for two military education programs, outside of the IMET framework. The Counterterrorism Fellowship Program, which already exists, "educates foreign military and civilians directly involved in the war on terror." And DOD also plans to propose a "Stability Operations Fellowship Program," which would provide "education and training in the areas of disaster response and preparedness, peacekeeping and peace enforcement, and stabilization and reconstruction missions."

- DOD has spent billions of dollars since 2002 providing budgetary support for coalition governments assisting the United States in the global war with terrorist organizations. This support reimburses cooperating governments for goods, services, and the costs to them of providing basing rights for U.S. military operations against terrorists. The FY 2007 emergency supplemental seeks another $1.0 b. for coalition support, while the FY 2008 GWOT emergency supplemental seeks $1.7 b. for coalition support next year. These funds are provided outside of the Economic Support Funding (ESF) program State and AID have led for years, providing support to strategic partners around the world.

It seems to make sense for DOD to carry out such programs; they have the skills, logistics, equipment, large budget, and direct contacts to provide these things. The combatant commanders (COCOMS) can, and do argue that only they can truly understand the local needs and move with the speed needed to prevail in the high intensity threat environment of the so-called "long war" against terrorism.

The State Department is said to lack sufficient budget resources and trained personnel for such programs, is not used to administering them, and, in the case of USAID, is focused on long-term development programs, not security and reconstruction. Moreover, it is argued, Congress provides funding more readily to Defense than to State/AID, and attaches "directives" and "earmarks," which constrain these agencies in responding to the emerging requirements of the GWOT.

There is some merit to all of these arguments. And there is some risk, as well. The military does not traditionally conduct foreign policy, and, in pursuit of the military mission, may not take into account the broad range of interests at stake in our relationship with other nations.

The State Department, in principle, has the perspective needed to embed such programs in our broader strategic relationships Historically, State has been given policy leadership; the budgets for such programs are requested as part of the international affairs budgets, not as part of the defense budget, and Defense has had major input into shaping the program and defining the requirement. Although the emergency budget request language includes the "concurrence of the Secretary of State" in these programs, initiating them and shaping the policy context will move to Defense.

There is a clear risk in changing our historical approach. I would call one risk the "snowball effect": the more we ask DOD and the military to do, the more they become responsible for our overseas relationships. Inevitably, DOD will want to expand the authorities for which they are responsible, as they will seek this year. The more we expand DOD authorities, and underfund State and USAID for such activities, the less State and USAID have the credibility and retain the competence to carry out policy leadership and program administration in these areas. This trend risks becoming a self-fulfilling prophecy.

There is another risk inherent in moving in this direction. The past four years suggests we need be cautious about the capabilities of our military forces for carrying out such missions as democratization, nation-building, or economic reconstruction. But they do and will salute and step up to the task, if asked. However, there is a down-side for our military capability when we divert our forces to these non-military missions. The more we ask them to carry out these programs, the more we risk diverting them from their principal mission and core capability: deterring and fighting the nation's wars.

Using DOD and the military forces as "one-stop-shopping" for security, reconstruction, training, and nation-building runs the double risk of underfunding and disempowering our diplomacy and foreign assistance agencies, and, at the same time, distracting the military from their core mission.

There is a third risk. As we ask our military to become the leading edge of our international engagement, we are putting a security face on that engagement. However benign and well-intended our forces, for other nations and peoples this can create a backlash against our policies and our presence. In the end, leading with our military chin could have the effect of endangering, rather than increasing, American security.

While this is not fully within the jurisdiction of this committee, the resources we provide for such defense programs are your concern, as are the resources we as a nation commit to strengthening our diplomacy, public diplomacy and foreign assistance. I would urge the committee to consider these issues as it questions administration witnesses on the contents of the proposed FY 2007 and FY 2008 budgets for both 050 and 150, and to consider ways in which our non-military instruments of statecraft might be adequately funded and strengthened.

Thank you for the opportunity to testify on these critical and timely issues. I welcome questions you may have.

Chairman CONRAD. Thank you, Dr. Adams.

Now we will turn to Dr. Gilmore, the Assistant Director of the Congressional Budget Office and the head of CBO's National Security Division.

Welcome, Dr. Gilmore.

STATEMENT OF J. MICHAEL GILMORE, ASSISTANT DIRECTOR FOR NATIONAL SECURITY, CONGRESSIONAL BUDGET OFFICE

Mr. GILMORE. Mr. Chairman, Senator Gregg, members of the committee, I appreciate the opportunity to appear here today to discuss Iraq war costs. My remarks will focus on the estimate of the cost of implementing the President's plan to increase forces in Iraq that CBO released last week.

At the request of the House Budget and Armed Services Committees, CBO has estimated the costs of that plan, in which CBO models the maximum increase in forces to span 4 months, namely from May through August, as well as two other scenarios increasing the span of that surge to 12 months and 24 months.

CBO estimates that the incremental costs, that is over and above the costs of the previously planned operations which would have sustained 15 brigade combat teams in Iraqi, of the President's plan would range from $9 billion to $13 billion through fiscal year 2009, with $7 million to $9 billion of that cost occurring in fiscal 2007. I will discuss the reasons for that range in just a minute.

If that increase in forces were extended to last 12 months, CBO estimates that costs through fiscal year 2009 would range from $20 billion to $27 billion.

Now CBO's estimates depend critically on the answers to three questions. How many additional troops will actually be deployed? How long will the deployments last? And what are the additional costs associated with incremental troop deployments? The rest of my remarks will focus on those three points.

The President announced his plan on January 11th, indicating it would comprise about 20,000 troops. The Administration has now confirmed that that figure referred only to the number of troops in the brigade combat teams to be deployed, not to the additional support troops that might be needed. All major military operations involve support units in the theater other than those included in the combat brigades. That is support at echelons above brigade and echelons above division.

Historical experience, including experience with Operation Iraqi Freedom, shows that substantial numbers of such support troops always accompany combat brigades deployed to conduct combat operations. Support functions performed outside the brigades include almost all logistics, higher-level headquarters, military police, military intelligence, signals—meaning communications—engineers, medical and other services. Providing the needed level of these services is essential to conducting an effective combat operation.

The number of support troops necessary to perform these tasks increases when the number of combat troops expands and, in particular, Army planning often assumes the need for these services increases in direct proportion to the number of combat troops in the theater. It is worth noting that it is difficult to rely on contractors to perform all of these services, particularly in combat zones.

The Army plans to, and has structured its force to, and historically has deployed one to two support personnel per combat person. Based on historical deployment data from DOD for Operation Iraqi Freedom, CBO's higher cost estimate assumes about 5,500 additional support personnel deployed to the theater per 4,000 person combat brigade. Those are average figures. Obviously, the composition of individual brigades differs. That is the average support-to-combat ratio for such deployments in Operation Iraqi Freedom since September 2003.

In that case, building the 20 combat brigades in theater will raise ground force levels from about 142,000 currently—and that is in the entire Iraq theater, including Kuwait and other areas—to 190,000 by May, an increase of about 48,000.

CBO's lower cost estimates assume that about 3,000 additional support personnel deploy to the theater per 4,000 person combat brigade. That number is consistent with the lowest support-to-combat ratio achieved in the Iraqi theater overall during the larger 18 brigade deployments that have occurred since September 2003. In that case, bringing the 20 combat brigades in theater will raise ground force levels from about 142,000 currently to 177,000 by May, an increase of about 35,000.

Now to put CBO's estimates in context, consider what happened during the increase in forces executed by DOD during the January 2005 parliamentary elections in Iraq. There were about 16 brigades and 137,000 ground forces deployed in the Iraq theater at the end of September 2004. Deployments increased to 20 brigades and about 189,000 personnel by the end of December 2004. Forces then fell to 17 brigades and about 165,000 personnel by the end of March 2005. Throughout that 6 month period the average increase or decrease in personnel averaged 9,200 per brigade, consistent with CBO's higher estimate.

And on November 17th, 2006, just last fall, DOD announced units for the upcoming Operation Iraqi Freedom rotation, including five brigade combat teams and a division headquarters comprising 20,000 personnel, an average of 4,000 per brigade combat team, as well as 37,000 support personnel. That was in the announcement. All told an average of 11,040 personnel deployed per brigade. Those are the support personnel DOD identified as needed in theater to service the brigades whose deployment is now being accelerated.

The Administration has recently suggested the possibility of much lower levels of support troops than those incorporated in CBO's analysis, stating that only 10 percent to 15 percent of CBO's estimates would be needed. Assuming that those percentages refer to CBO's high case estimate of 28,000 support personnel, that would imply that DOD plans to deploy about 4,700 total personnel per newly deploying brigade. This would result in support-to-combat ratios in the overall Iraq theater during the upcoming increase significantly lower than any indicated in the OIF deployment available to CBO.

CBO has not explored the implications of conducting such a historically anomalous deployment in which the number of troops in combat brigades theater-wide would increase by 33 percent with a corresponding increase in higher echelon support personnel of 4 percent.

As I indicated previously, the length of the maximum increase in force levels analyzed by CBO spanned four to 24 months. Costs for increases of different durations are roughly proportional to the total length of those increases, including the 3-month buildup and ramp down period CBO assumed. Thus, through 2009 the 24 month increase, spanning 30 total months, would cost three or four times more than the 4-month increase, spanning 10 total months.

All of the force increases CBO considered would require that DOD's goals for the use of its active and reserve forces be exceeded by more than they have been over the past year. CBO has not yet analyzed the implications of those increased levels of stress on our forces.

Now as Steven Kosiak mentioned, we find estimating the cost of the wars in Iraq and Afghanistan difficult and have routinely underestimated the costs relative to the Administration's requests. Estimation is difficult for all of the reasons Steve mentioned, because thus far the available cost reporting and budget justification information have lacked sufficient detail to prevent robust cost estimating relationships to be developed. And some of the support material that I reviewed last night that accompanies the President's budget submission, the supplemental submission, and the new budget lack the kind of detail that we would need still, although there may be more details coming.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Gilmore follows:]

CBO TESTIMONY

Statement of
J. Michael Gilmore
Assistant Director for National Security

Estimating the Costs of Military Operations in Iraq

before the
Committee on the Budget
United States Senate

February 6, 2007

This document is embargoed until it is delivered at 10:00 a.m. (EST), Tuesday, February 6, 2007. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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Mr. Chairman, Senator Gregg, and Members of the Committee, I appreciate the invitation to appear before you today to discuss the costs of operations in the Iraq theater and issues associated with estimating those costs. My statement is based on the Congressional Budget Office's (CBO's) recent estimate of the costs of the President's plan to increase U.S. forces in Iraq as well as on other analyses of war-related costs that CBO has performed during the past few years.

This testimony will briefly discuss CBO's estimate of the costs of the President's plan and other scenarios for increasing forces in the theater. It will also discuss some of the budgeting and reporting issues that make it difficult for CBO to estimate the costs of military operations in Iraq.

Costs of the President's Plan to Increase Forces in Iraq and of other Scenarios for Increasing Forces

At the request of the House Armed Services and Budget Committees, CBO has estimated the incremental cost of the President's plan to increase the number of military personnel deployed to Iraq under different scenarios related to the duration of that increase. CBO estimates that costs would range from $9 billion to $13 billion for a four-month deployment and from $20 billion to $27 billion for a 12-month deployment, depending upon the total number of troops deployed and including additional costs that would be incurred during the build-up and ramp-down periods.[1] Those incremental costs would be in addition to the $8 billion to $10 billion per month in obligations that the current level of activities in Iraq have required.

The analysis depends critically on three key factors:

- How many additional troops will be deployed?
- How long will the deployments last?
- What are the additional costs associated with incremental troop deployments?

Number of Additional Troops

The President has announced an increase in Army and Marine Corps forces to be deployed to the Iraq theater of operations. Over the next several months, that increase will be accomplished largely by deploying troops sooner than was previously planned and by lengthening the deployment of forces already in the Iraq theater. The increase in force levels has already begun and is expected to reach its peak of about 20,000 additional combat personnel in May 2007.

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1. CBO's analysis focuses only on the costs associated with deploying ground forces in Iraq. It does not encompass the costs that will be incurred for deploying additional naval forces to the Persian Gulf.

Achieving that peak and sustaining it will require the deployment of forces and the extension of the tours of units in Iraq beyond those announced publicly by the Department of Defense (DoD) to date.

Thus far, DoD has identified only combat units for deployment. However, U.S. military operations also require substantial support forces, including personnel to staff headquarters, serve as military police, and provide communications, contracting, engineering, intelligence, medical, and other services. Over the past few years, DoD's practice has been to deploy a total of about 9,500 personnel per combat brigade to the Iraq theater, including about 4,000 combat troops and about 5,500 supporting troops.

DoD has not yet indicated which support units will be deployed along with the added combat forces, or how many additional troops will be involved. Army and DoD officials have indicated that it will be both possible and desirable to deploy fewer additional support units than historical practice would indicate. CBO expects that, even if the additional brigades required fewer support units than historical practice suggests, those units would still represent a significant additional number of military personnel.

To reflect some of the uncertainty about the number of support troops, CBO developed its estimates on the basis of two alternative assumptions. In one scenario, CBO assumed that additional support troops would be deployed in the same proportion to combat troops that currently exists in the Iraq theater. That approach would require about 28,000 support troops in addition to the 20,000 combat troops—a total of 48,000. CBO also presents an alternative scenario that would include a smaller number of support personnel—about 3,000 per combat brigade—totaling about 15,000 support personnel and bringing the total additional forces to about 35,000.

Length of Deployments
CBO estimated costs for a number of different deployment periods, ranging from four months to two years. In each case, the period identified is the length of time that the peak force levels would be sustained. In each case, there is also a three-month period during which forces would be gradually built up, and a similar period following the peak during which the force levels would gradually decline.

Costs of Increasing Forces
Estimating the costs of deploying additional troops to Iraq is difficult. DoD prepares monthly reports on budgetary obligations incurred in support of the war, but those reports do not contain sufficient detail on many cost elements, nor do they include information on key factors such as personnel levels or the pace of operations. As a result, they are not very useful in developing cost estimates.

In the absence of sufficient information from the monthly obligation reports or other sources, CBO based its estimates on appropriations provided in 2006 for operations in Iraq and Afghanistan and for the war on terrorism—a total of $116 billion—and subtracted from that amount the costs of activities not likely to vary significantly as a result of changes in the number of deployed troops. CBO estimates that, in total, $89 billion of the funding provided in 2006 for personnel and personnel support, equipment repair and replacement, operating support, and transportation was related to the size of the deployed forces. CBO then projected costs for operations in Iraq in future years on the basis of changes to those forces that would occur under the two scenarios specified above. Most costs would be incurred during the deployment, but some of the costs to restore or replace damaged equipment could lag behind the end of the deployment by a year or more.

Results of CBO's Analysis
If DoD deployed a total of 48,000 troops and sustained that level for four months, costs would be about $13 billion higher than for the current force levels, CBO estimates (see Table 1). The 20,000 combat forces account for $5 billion of that cost. If the higher troop level was maintained for 12 months, costs would be $27 billion greater than the current level—$11 billion of which would fund the combat forces alone. Costs would increase by lesser amounts if the combat forces were accompanied by fewer support personnel. If additional forces totaled 35,000 troops, sustaining such a deployment would cost $9 billion for four months and $20 billion for 12 months, CBO estimates.

A substantially longer deployment would cost much more. A 48,000-person increase in deployed forces sustained for 24 months would cost $49 billion, in CBO's estimation; a corresponding 35,000-person increase would cost about $26 billion.

CBO's analysis does not incorporate any effect on federal tax revenues from an increase in the number of troops serving in combat zones, nor does it include any indirect effects on spending (from changes in veterans' benefits, for example). Finally, CBO's analysis does not address the effects that sustaining such increases in deployed forces would have on military readiness and other operational considerations.

Budgeting and Reporting Issues

Since September 2001, by CBO's reckoning, the Congress has appropriated $503 billion for military operations and other activities related to Iraq and the war on

Table 1.

Estimated Funding Required to Increase the Number of Personnel Deployed to Iraq Under Alternative Scenarios

(Budget authority in billions of dollars, by fiscal year)

	2007	2008	2009	Total, 2007-2009
Four-Month Peak Deployment				
Sustain an Additional 48,000 Troops in Iraq (20,000 Combat Troops and 28,000 Support Troops)	9	3	*	13
Sustain an Additional 35,000 Troops in Iraq (20,000 Combat Troops and 15,000 Support Troops)	7	2	*	9
Twelve-Month Peak Deployment				
Sustain an Additional 48,000 Troops in Iraq (20,000 Combat Troops and 28,000 Support Troops)	10	15	3	27
Sustain an Additional 35,000 Troops in Iraq (20,000 Combat Troops and 15,000 Support Troops)	7	11	2	20

Source: Congressional Budget Office.

Notes: * = less than $500 million.

Each scenario includes the cost of a three-month buildup and a three-month drawdown.

terrorism, including $70 billion appropriated so far for fiscal year 2007.[2] Through the end of fiscal year 2006, appropriations to DoD for those purposes had totaled $463 billion, and DoD's outlays for Iraq and the war on terrorism had reached an estimated $310 billion. The President's budget includes a request for another $94 billion for this year and $142 billion for 2008. For fiscal year 2007, CBO estimates that funding for operations in Iraq and the war on terrorism will add

2. For additional detail regarding funding for activities in Iraq and the war on terrorism, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007), Box 1-1.

between $115 billion and $120 billion to total outlays, assuming that additional appropriations are provided during the course of the year.

CBO has been asked by the Congress on several occasions to estimate the future costs of operations in Iraq and for the war on terrorism. As I stated previously, estimating war costs is always difficult. However, better estimates could be provided to the Congress if more information was available on the costs incurred to date. In particular, CBO has identified four main concerns regarding the current process of budgeting and cost reporting for operations in Iraq and the war on terrorism.

The Timing of Budget Requests

Since fiscal year 2001, funding for activities in Iraq and the war on terrorism has been provided through a combination of partial-year appropriations (sometimes referred to as bridge appropriations), which are enacted near the beginning of a fiscal year, and midyear supplemental appropriations. If the bridge appropriations run out before enactment of the midyear appropriations, DoD can pay for war-related expenses using funds meant for its regular activities, which are then reimbursed upon enactment of the midyear supplemental appropriations. In the event that the midyear appropriations are delayed and funds for DoD's regular activities begin to run out, the department has some options. One option is to use its authority to transfer funds among various appropriation accounts (for instance, from procurement accounts to operation and maintenance accounts), although that authority is limited. In addition, DoD can invoke the Feed and Forage Act (41 U.S.C. 11), which allows the President to obligate funds without an appropriation for the purpose of sustaining troops in the field. That authority was invoked immediately after the terrorist attacks on September 11, 2001, although ultimately it was not used because the Congress quickly provided the necessary appropriations.[3]

Some policymakers and analysts have suggested that, to better assist in planning future defense budgets, DoD should include the entire fiscal year's cost of operations in Iraq and for the war on terrorism in its regular budget request. As I just noted, in its fiscal year 2008 budget request DoD has included $142 billion to pay for future military operations in Iraq and Afghanistan and for other potential operations worldwide associated with the war on terrorism. That approach has both positive and negative consequences. On the positive side, including war costs in the regular budget request gives the Congress more time to debate and modify the request for those activities. It also gives the budget committees more

3. The authority of the Feed and Forage Act is limited to obligations for items meant to sustain troops in the field, such as subsistence clothing, fuel, quarters, transportation, and medical supplies. It cannot be used to purchase additional weapons or to support military hardware.

information about potential budgetary effects that they may wish to consider in crafting a budget resolution. Further, fully funding those operations at the beginning of a fiscal year helps DoD avoid any potential funding issues that might arise from a delay in enacting midyear supplemental appropriations. On the negative side, submitting the request at the beginning of a fiscal year could lead to less accurate cost projections because the budget must be submitted in February (eight months prior to the start of the fiscal year).[4]

Supplemental Budget Requests

DoD's supplemental budget requests often do not provide enough detail to determine how the department develops its budget requests. The amount of justification material that DoD provides in its regular budget for activities besides the war in Iraq and the war on terrorism and the documentation that it submits for war-related operations differ substantially. The $440 billion requested by DoD for its regular activities in fiscal year 2007 was supported by very detailed justification documents. By contrast, DoD's funding requests related to the war have been accompanied by relatively little backup material. For instance, the backup material for the department's original 2006 supplemental request, which totaled about $68 billion, included only five pages on operation and maintenance costs, even though those costs constituted almost half (about $33 billion) of the request.

In June 2006, DoD provided the appropriations committees with a package of information on the $50 billion that the Administration had requested for war-related activities for fiscal year 2007. Compared with previous submissions, that material provided more detail on the request, although not enough to enable analysts to understand how the costs were estimated or to explain how the funding requirements compared with those of previous periods.

Tracking Actual War-Related Obligations and Outlays

Regardless of when the funds for operations in Iraq and for the war on terrorism are provided, they are generally recorded in the same appropriation accounts that fund DoD's other activities, making it difficult to sort out how much is ultimately spent on the war.

For fiscal year 2006, the Congress appropriated about $218 billion to DoD's operation and maintenance accounts. Of that amount, about $72 billion was appropriated for war-related activities and about $146 billion was appropriated for DoD's regular operating costs. But the standard budget execution reports submitted to the Office of Management and Budget do not distinguish between

4. Much of agencies' budget preparation occurs long before the February budget submission.

those war and nonwar expenditures, making it difficult to determine how much has actually been spent for activities related to Iraq and the war on terrorism.

The Defense Finance and Accounting Service issues monthly reports that track war-related obligations, but they provide limited information. According to those reports, about $98 billion was obligated for military operations in Iraq and the war on terrorism in fiscal year 2006. Of that amount, almost 25 percent ($23 billion) was allocated for purposes described as "other." Little information was provided to suggest how those "other" funds were obligated. Without a better understanding of those expenditures, determining whether such costs will be incurred in future years is difficult. Moreover, the extent to which the reports capture obligations for classified activities is not clear. Relying on conference reports for various supplemental appropriation acts, CBO estimates that at least $25 billion has been appropriated for classified activities since 2001. In addition, the obligation reports have not contained information on the pace of operations—such as troop levels, flying hours, or vehicle miles—in each month. Such information would be useful in analyzing cost variations, which CBO and other government analysts could use to better estimate future spending on the war.

Setting up separate budget accounts might help in tracking the obligations and outlays of war-related appropriations, but implementation of such an accounting structure might be difficult. For instance, it would necessitate distinguishing between the basic pay of troops (which is part of the regular defense budget) and their additional combat-related pay (which is attributable to the war).

The Distribution of Data and Information

CBO frequently has difficulty obtaining monthly reports on war obligations and other data. Often the agency receives that information months after the data are officially approved for release. That problem could be addressed by establishing a standard, more-comprehensive distribution list for the war-obligation reports and other data.

Chairman CONRAD. Thank you, Dr. Gilmore, for that testimony.

Let me just indicate that we have a pattern here of the Administration hiding the ball from the Congress and the American people on the cost of this war. It started at the beginning and it has continued right through. Until last year they told us in every one of their budget submissions there was not going to be any cost to the war. Last year they told us it was going to cost $50 billion and we are at $163 billion and counting.

Now you tell us, Dr. Gilmore, that the so-called surge or the escalation which the Administration has told us is going to cost $5.6 billion, you have told us that if it lasts a year the more likely cost is $20 to $27 billion.

Have I got that right? That your estimate for a year-long additional deployment as called for in the President's plan would be in the range of $20 to $27 billion?

Mr. GILMORE. If the increase were extended to 12 months, including 3 month buildup and 3 month ramp down, the total cost through 2009 that we estimate would be $20 to $27 billion.

Now for our understanding of what the President's plan calls for at this point, which is a buildup hitting about 20 brigades in theater in May, extending through August, and then a ramp down, the total costs through 2009 would be $9 billion to $13 billion, and in fiscal year 2007 would be $7 billion to $9 billion, depending on the level of support forces.

Chairman CONRAD. Let me just say, the President has told us consistently that he is opposed to a timeline. It all sounds like a timeline to me. For 2008, he is calling for $140 billion; for 2009, $50 billion; in 2010, no money. If that is not a timeline, I do not know what a timeline is.

And with respect to the escalation, the President is saying it is going to cost $5.6 billion. If that is accurate, what could we conclude would be the amount of time that this escalation would last? Based on history of what these troop levels cost.

Mr. GILMORE. Well, $5.6 billion would be a shorter increase in forces than the 4-month increase that we have estimated. Now, we have seen none of the detail behind that $5.6 billion. I have heard that $2 to $3 billion of it is associated with the naval forces, the deployment of the additional carrier to the Persian Gulf and then covering for what that carrier would have done in the Western Pacific by having the Ronald Reagan sail and pick up the Kitty Hawk Air Wing.

Chairman CONRAD. That would make the estimate even further off then.

Mr. GILMORE. Yes.

Chairman CONRAD. Because your estimate does not include naval costs.

Mr. GILMORE. Our estimate excludes naval costs. So if it were $2 billion, if it were really $2 to $3 billion, then it would be a surge that would compose a length a third of the one that we have looked at.

Chairman CONRAD. One third of how long?

Mr. GILMORE. It would just be a month or two, according to our estimates which, of course, the Department disputes.

Chairman CONRAD. When you hear the Department say they are going to do this but they are only going to have a troop level over and above the combat troops that are deployed of 10 or 15 percent in terms of the cost, what is your reaction to that based on your professional experience?

Mr. GILMORE. I don't understand it.

Chairman CONRAD. Do you believe it?

Mr. GILMORE. As I said, I do not understand it. We have asked for additional information. In fact, we met with the Army on January 25th. Unofficially, we received information which is consistent with the estimates that we made in terms of the number of support forces, but obviously Secretary Gates is disputing that.

I can only point out again that our estimate is based on our understanding of Army planning, we do understand that, and on historical experience, and I am not talking about ancient historical experience. I am talking about recent historical experience. I went through the force levels that occurred during the increase in forces to cover the parliamentary elections. At that point they had 20 brigades in theater, 189,000 forces. Our estimate would be 190,000 troops in the theater. Our higher estimate would be 190,000 troops in the theater beginning in May, when they hit 20 brigades.

As far as I understand what the Administration is saying at this point, they would say that there would be 160,000 to 166,000 troops in theater in May.

And that is just absolutely inconsistent with Army planning, what we know of Army planning, and what the Administration has executed in the past and what the Administration announced last November in terms of the needed support package for the forces that are going to be part of the rotation.

Chairman CONRAD. Let me just say that in looking at this, it seems to me that the Administration's claim is just not credible. It is not credible based on what the history has been, not only in this conflict but other conflicts. It is not credible with respect to what we have seen in Iraq.

Senator GREGG.

Senator GREGG. Thank you, Mr. Chairman.

It appears we went through a surge in 2004 that was actually larger than what the President has proposed in 2007; is that correct?

Mr. GILMORE. It was a surge of about the same size, as far as we understand. It was up to 20 brigades. It hit 20 brigades in January and then it ramped down by March, so it was actually a bit of a shorter surge.

Senator GREGG. So we have been through this exercise before.

Mr. GILMORE. Correct.

Senator GREGG. The issue which you raise, Mr. Kosiak, of the supplemental being used to fund the base, can you document your view on that, that the supplementals have been used to fund the base, and that the supplemental that we are going to get, I presume in February, will be used to fund the base? Can you document that in the specifics?

And can you highlight and get us a paper to that effect? And pending your doing that, in specifics, could you sort of highlight what you see as some of the costs that have been in past supplementals and that you would see coming in the future supplementals, other than the Army modularity issue, which we are all familiar with, that you think are base issues versus war fighting issues?

Mr. KOSIAK. That is an excellent question and it is hard to do that. I will try to answer it partly at least.

Because of the justification materials, problems with the justification materials, it is hard to tell, it is harder to tell than it might otherwise be. But I think there are a couple of reasons to suspect that this is going on.

One is that if you look at the Administration's request, if you look at the level of funding that was provided in 2006 for military operations, about $116 billion for the Department of Defense, and compare that with the $163 billion projected for this year, that I think raises questions as to why costs have grown that much, because it would not be explained simply by an increase in the number of troops.

Also, if you look at OMB's own estimates of what the costs were going to be for 2007, up until as late as August of 2006, they were estimating total cost for the global war on terror in 2007 of $110 billion versus $163 billion.

There are also, if you look at some of the programs like the Joint Strike Fighter, it seems to me programs that really belong in the Department's long-term plans not in their short-term special global war on terror funding, which is sort of emergency funding.

Also, if you look at their funding totals in the 2007 supplemental and for 2008, they include I think for 2007 the total amount of funding provided for reconstitution or what had been called reset, is about $37 billion. That seems substantially higher than what they were estimating a short time ago.

My understanding was that the Army and Marine Corps basically said that the $23 billion that was provided in the 2007 regular appropriations, the $70 billion that Congress provided in 2007 in their bridge fund, that the $23 billion in that that was for reconstitution was what they needed. So to get an additional chunk of money to bring it up to about $37 billion for 2007 just raises, I think, my suspicion.

And then finally, go back to the memo by Gordon England, which invites this to happen.

But it is hard to pinpoint particular programs.

Senator GREGG. I appreciate that brief thumbnail review of it, but do you think you could do a little more extensive review and get it to us?

Mr. KOSIAK. Yes, I would certainly be happy to try to do that.

Senator GREGG. I understand O&M costs are fungible, but I would be interested to know what percentage of the O&M costs that we are hearing is war fighting is really not war fighting, it is simply base operation activity. So I thank you for that.

This whole issue of developing the emergency, I think it was Dr. Adams who said that when the Pentagon develops their emergency supplemental request they do it outside their own budget criteria. I have always thought the biggest problem is that it gets outside our budget criteria. But I had not thought of it, in the terms that it actually goes outside of the Pentagon's criteria.

What is the practical effect of it skipping the Pentagon's budget criteria internally? I know what the practical effect is here, it does not go through the authorizing committee and the appropriating committee ends up looking at it with about a 48-hour window.

But what is the practical effect for this occurring at the Pentagon level?

Mr. ADAMS. There are a couple of effects. Emergency supplementals are developed with a timing that puts them outside the normal PPBES cycle in the Department of Defense. They generally happen when, as Deputy Secretary Gordon England did in late October, the Deputy Secretary sends guidance to the services and says come back within this given timeframe with the programs and data you will require to go into the fiscal year 2007 second supplemental.

Anything that is in that response has not gone through the scrub of PPBES, where there is an orderly process of looking at all these requirements, determining whether they are absolutely needed, winnowing out things that are not necessary, trading them off against other programs in the budget cycle when you know you have a funding limit.

Without that funding limit, the temptation is to do what Steve Kosiak was talking about, put things into that budget that you were not able to obtain through the normal PPBES cycle.

That is most clear with hardware programs like the F–35. Because of the fungibility of O&M, it is harder to sort out what goes to war costs and which does not. The Pentagon does not give us data to help us do that.

So in part, the problem is that things that should be in the normal budget process get hived over into a supplemental process that is not going through the same kind of scrub and the same kind of tradeoffs.

The consequence of that for those who work the PPBES process in the Department of Defense is that they never quite know what is in and what is out, what they are being asked to scrutinize, what they are not being asked to scrutinize. This has a dispiriting effect on the job that they do in the PPBES cycle.

If their job is to say A is more important that B, that hardware program is more important than this alteration in the force structure, or pay or benefits or whatever one proposes, and they are told do not worry about it, we will go over to the supplemental to get it fixed, then the integrity of their own process is called into question.

So it has that kind of effect on their process, the dual process they have there.

Senator GREGG. Thank you, very much.

Chairman CONRAD. Senator Murray.

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

I think this hearing is very important and it is critical that we get, finally, the facts on the cost of this war so we can hold this Administration accountable and, from my point of view, change the direction we are going in Iraq.

Listening to your opening statement, Mr. Chairman, it was stunning to remember what we have been told about the cost of this war. I remember in 2003 when the White House Budget Director said the war would cost $60 billion, and now what are we, six times past that?

I remember Defense Secretary Paul Wolfowitz telling us that Iraq would finance its own reconstruction. I remember Vice President Cheney, back in 2003, saying Iraqi oil would cover the costs of reconstruction. Obviously none of that has come true.

And at the same time we are paying for this all off budget, in a supplemental, which really hides the true cost of the war.

So this, I think, is really essential that we have this hearing and have an understanding so we can make critical decisions about the future.

I am sorry Senator Gregg left. I did want to respond to one thing he said in his opening statement. I am deeply troubled that the Republican leadership did not allow us to go to a floor debate on the surge in Iraq. Senator Gregg mentioned his amendment as part of that.

It is the fact, my colleagues should know, that Senator Reid has offered, on more than one occasion, a vote on the Gregg Amendment up or down, along with several other resolutions. His amendment really talks about the cost of war, which is a debate we are going to have on the budget and on the supplemental and I am sure many other things.

The point of the debate that we want to have is about the surge. And critically to this budget hearing, we need to know how much that is going to cost. I am deeply concerned that we are going to be sending our troops overseas without a vote of the Senate, without a discussion in the Senate, and they will not have the equipment and the supplies they need because we have not adequately budgeted for it. And I think that should be of deep concern to every one of us in this committee and in this country.

I would say, as the Senator representing Washington State, that has striker brigades going over, these are families that we are responsible for.

So I am troubled, Dr. Gilmore, when I heard your statements about CBO's estimates versus what the Administration is saying, that this is 48,000 troops. I understand that Secretary Gates said that the support troops would only number 10 to 15 percent of the CBO estimate. I would like to know who is right and who is wrong? Can you fill us in?

Mr. GILMORE. As I said earlier, I do not understand the basis for what the Secretary said. As I said, we have asked the Army about this and received some information. We will meet with them again and perhaps receive some more.

I can only just say again that our estimate is based on recent historical experience and what we understand of Army planning. We would have, in our higher estimate, force levels of about 190,000 in theater and 20 brigades. That is consistent with what happened in January 2005.

Senator MURRAY. Which is the surge that Senator Gregg was talking about?

Mr. GILMORE. Correct. And it is consistent with what we know of Army planning, which is that they deploy one to two support people for every person in a combat brigade.

So I do not know what more to say. I am just trying to explain to you why we think our estimates are reasonable and what the basis for them is. We have asked for information from the Department about the basis for what they apparently are saying they are going to do and we have not received it. We are anxious to receive it.

If they do do that, if they do deploy with that smaller number of support forces, then it would be inconsistent with what we understand of Army planning, certainly inconsistent with the history of these deployments, and I think that it would then mean that the Administration is willing to accept risks that they are not normally willing to accept in order to execute this deployment.

There can be good reasons for that.

Senator MURRAY. That is deeply disconcerting. Without a vote or a discussion or debate in the Senate, the President has been given the green light to move forward with the surge. And from what I hear you saying to us, not making sure that our troops that are going to then be on the ground have the support, the supplies, the equipment, and the training that they need.

And to this Senator, that is very, very troubling. It seems to me that what we have is the Bush Administration just trying to minimize the number of troops that will be required so we do not question it.

Maybe our other witnesses would like to comment on why they think there is such a discrepancy between what we are being told this will cost by CBO and what we are being told it will cost by the Administration.

Mr. ADAMS. Senator, I know no more than Mike Gilmore, having not directly pursued the Pentagon myself, and I know they have pursued the Pentagon assiduously to try to get data on what explains this discrepancy. I would be making assumptions.

One assumption might be they think existing support in field is adequate to cover the increment of troops that they are sending, which does not sound true to historical practice in the Pentagon.

Senator MURRAY. Nor does it sound true to my ears, just as an observer. If you are going to keep Stryker brigades on the ground longer, they are going to be still using their equipment. If you send over other brigades earlier that they are supposed to, they are going to need equipment. So you do not have duplicate equipment.

It does not make sense to me.

Mr. ADAMS. I think you are right, Senator, they will need the support. I am not sure that the support in the field is going to be adequate for what they require. But I do not have independent knowledge of what has moved them to this particular judgment.

Senator MURRAY. Medical officers, people capable of helping them in the field? This is really disconcerting.

Mr. ADAMS. There is a history of now, since 2003, of both underestimating the cost and underestimating the requirement. I worry that we may be in another situation where that is the case, that we have understated for reasons that I cannot describe, perhaps just not worry too much about the impact. The consequence of this, of course, is it takes longer and it is a lot tougher job to do.

Senator MURRAY. Mr. Kosiak?

Mr. KOSIAK. I would just say that I think CBO did the analysis the only way you could do the analysis and it is up to the Pentagon, I think, to explain why that does not make sense.

Chairman CONRAD. Thanks, Senator.

Just for the record, I would like to make sure that we get it very clear that the support personnel that you are talking about are logistics, police, intelligence, engineers, communications, medical.

What other support personnel, Dr. Gilmore, are we talking about here?

Mr. GILMORE. Those are the ones that I highlighted in my verbal remarks.

Chairman CONRAD. So we are talking about, we just now have a—

Mr. GILMORE. These are all support personnel outside the brigades. The Pentagon likes to make the point that the new brigade combat teams have support integrated within them, and that is true.

Chairman CONRAD. That has been the case in the previous surge, is it not?

Mr. GILMORE. Yes. In the previous surge, not as many of the brigade teams were modular. But even in the Army before it was modularized, when they deployed brigade combat teams, they would pull the support down from division and then it would be incorporated as part of the brigade combat teams and deployed. Now it is integrated.

But that is not the support we are talking about. That support is there to receive things from higher echelons. And the support we are talking about is that support at higher echelons.

Chairman CONRAD. Is there any possibility that they are using contractors for these purposes?

Mr. GILMORE. They certainly do use contractors for things like feeding and housing and that sort of thing. We did a study back in late 2004 of the costs of what is still called the Logistics Civil Augmentation Program that at that time was being executed by KBR. At that time they had a substantial presence in the theater of over 38,000 people. That was just that contractor element.

And the costs were about $5 billion a year. From what I have seen of the budget justification material, that has risen to about $6 billion a year. The Pentagon likes to make the point that the theater is mature and perhaps because of the support that is there and all the contractors that are there we do not need as many support forces to accompany the units in this surge.

I would just simply point out that at least the so-called LogCAP, Logistics Civil Augmentation Program contractors were there in force in 2004 when the increase was executed during the parliamentary elections. And the level that they are funding those kinds of activities now is about the same as they were funding them then.

Chairman CONRAD. We have a real discrepancy and it has been repeated. I have just been handed a news account that the Secretary has repeated that they will add as many as 3,000 troops to the 21,500 and we think the number is going to be around 21,500. Secretary Gates told a Senate panel that it would not be more than 10 percent more, 10 to 15 percent more, which directly contradicts the estimates that you have provided, which been based, as I take it, on what has happened historically.

Senator ALLARD.

Senator ALLARD. Thank you, Mr. Chairman.

We have heard testimony here where the cost has not related to the number of troops that get deployed, particularly when we are looking at a cost per troop basis. Has there been any attempt to analyze it as it might relate to the level of arrests and occurrences of violence and everything within Iraq or other countries? We have had surges, you understand, where we have had increased violence in these various countries. I am wondering does anybody suspect any correlation to the level of violence?

Mr. KOSIAK. My understanding is that according to Department of Defense reports, that only about 10 percent of the costs for the global war on terror are those kind of costs that vary with operational tempo, which is what I think you are getting at, the more intense military operations. So that having these more intense military operations, most of the costs are really driven by the number of troops that are deployed and all the sustainment costs, reserve activation, things like that. Actual operational tempo doesn't tend to have that big an impact.

That may well have had some impact, but I think we need—and maybe it has a bigger impact. But we do not have the data from DOD to have that verified, I think.

Senator ALLARD. You know, when we started this conflict, we did not have enough body armor. And so a big effort was made for body armor. It was sort of delayed because the manufacturers could not keep up with demand. And I assume that when they have to go and on a short-term basis ramp up their manufacturing lines or what not, I suppose they do not do that on the cheap because they have to recover the costs quicker.

Then after that, we had issues about the Humvees having to reinforce the underside. We see the same phenomenon there. And then we see the striker, for example, vehicle. That vehicle is a very modern kind of a vehicle, loaded with technology.

How much of a factor have these things played in trying to make our environment more secure, make the soldier more secure on the ground in Iraq? Has there been any effort to analyze that?

Mr. KOSIAK. I guess the only thing I would add is that even if you look at these numbers and you take out the amount that has gone to procurement and reconstitution or reset, you still see—it is not as large a trend. I think that explains part of it.

But even when you take that out of the initial cost estimates and the later cost estimates, you still see a significant growth in costs.

There presumably are answers to this, and I am not suggesting that all of this is nefarious on the part of the Pentagon, by any means.

The bottom line is the data we have does not provide us with a real handle on what is driving those costs. And so it makes it very difficult to look at DOD's justification details and figure out is this the right amount of funding? And also very difficult to look forward and try to guesstimate about how much we are going to need in the future.

Senator ALLARD. We have made an effort to bring some accountability to the process by making this part of the regular budget request. It has been going on for a while to see that, where we can look back and make some analysis there and what we are going to do there and build in inflation and what not. Probably do a little better job of that. And that means that we will have more oversight, I think, if we go through the regular process from the various committees, authorization and appropriation both.

One of the things that happens over time, I think, is that the base can get built artificially high during times of conflict. We have tried to manage this by setting up an emergency fund and then going back and providing that.

Anybody have any thought on how we manage a fund like that? The war is not going to go forever yet there will be a build in to the base there. And when that does drop down, how do we manage those appropriations? Or do you just think it is the best thing for the Congress to look at on a year-to-year basis and say well, our priorities have changed, we shift dollars, or we cut back on spending? How do we deal with that?

Mr. ADAMS. I think the first step, Senator, is one that the Department of Defense has at least opened the door to by providing a much larger volume of justification for the supplemental requests, for the war than they have provided in the past.

Senator ALLARD. So we are getting more detail on the requests now.

Mr. ADAMS. A first step has been taken. I have had a chance to glance through some of that. I have to share, to some degree, Mike Gilmore's view that it is not quite clear that there is enough there to really tell what this is going to cost, but it is a lot more than we have had. That is two very thick documents, at this point, worth of justification and they have said they will deliver even more justification than that.

So step one, I think, is for this committee and the other committees responsible to take that documentation on board and scrub it very, very hard to make sure that the right things are in place for the right reasons.

You will find things that are going to demand very close scrutiny. One that is of interest to me is the rather large and rapidly growing investment that we have in continuing what is the major source of casualties of our troops in Iraq, and that is IEDs. There is now an enormously expensive $6 billion request for the IED Center that is looking at technologies and ways to combat the IED threat in Iraq and Afghanistan.

Given the volume of that expenditure, it is worth taking a look at now, what they are producing, whether they are producing results, how they are being tested on the ground, whether they are working, whether they are in fact reducing casualties and reducing fatalities in Iraq.

So there are bits and pieces now that you can pull out and say all right, give us a witness on this, give us some documentation, give us a bit more.

In a broader sense, the concept of creating a kind of "sidecar", which is what Senator Gregg was referring to, for war costs is a good idea. It will help you deal with some of the very knotty issues, about what is appropriate to the war and what is not appropriate to the war.

One of the big areas that you are going to need to look at is this reset issue, with $37 billion in the request. You really need to go into that reset program and say all right, which of these are really contributing long-term hardware capabilities for the long-term operations of the United States military? And which are reset costs that involve taking equipment that suffered severe damage from either the weather, operations on the ground, or combat and fixing it so it is re-usable?

There is a gray area in there. If you buy a new and improved Abrams tank or a new and improved infantry fighting vehicle, have you really bought it because you intend to deploy it for the war? Or are you buying it because it is next in line, it is the next program that you need to reset the force, to equip an expanded force?

So pushing very hard to get those details separated out and worry the troubled gray areas in hardware, in O&M, is a very important first step to answering your question.

Senator ALLARD. And replacement costs are a problem when you are in such a harsh environment.

Mr. ADAMS. Absolutely.

Senator ALLARD. All the sand and everything, your depreciation on the vehicle is so much—

Mr. ADAMS. Clear wear and tear on the equipment.

Senator ALLARD. If I might, just one other thing, on benefits to the people who serve over there, have you looked at that at all? There are going to be veterans and there will be veterans benefits. And I guess this could be attributed to the costs. I wonder if you have tried to extrapolate that in as a long-term cost, medical care and what not?

Mr. ADAMS. Some of the work that I have seen has been done at CBO.

And there is some that the CRS has done. And there is some that Professor Linda Bilmes at Harvard has also done. There is a very broad range of what those costs may be; CBO's is on the low end of the range, as I understand it.

Mr. GILMORE. It is about $1 billion a year.

Mr. ADAMS. Bilmes's is a very high end, $300 to $600 billion over the lifetime of the veterans affected.

That is an issue that is very much worth looking at long-term because the implications of that in budgetary terms are very, very large.

Senator ALLARD. Thank you.

Chairman CONRAD. I thank the Senator.

Let me just indicate that I have just been notified that Secretary Gates now, who was scheduled to come before the committee next Thursday will not come before the committee next Thursday.

I just say that I find that very disappointing. We have serious issues that have been raised and for the Secretary to now change what was a commitment to this committee is just unacceptable to the committee. I just want to make that very clear.

This is an overwhelming driving element to this budget. And for the Secretary, who was scheduled to come here next Thursday, this morning to tell us now he will not come, I just find unacceptable.

Senator SANDERS. Mr. Chairman, just a point on this.

It is not just unacceptable. This is a huge amount of money that impacts education, health care, every aspect of our life.

I would hope that this committee acts in a very strong way. Why should we give consideration to a budget when they refuse to send analysts up here to defend the budget or the Secretary to tell us why they need it?

Chairman CONRAD. I think it is very clear this committee, I think on a bipartisan basis, will be very disappointed, in the least. And I just find it unacceptable that the Secretary had committed to coming before this committee next Thursday to talk about what is absolutely central to the deliberations on the budget. And now the Secretary does not want to come.

Senator STABENOW.

Senator STABENOW. Thank you, Mr. Chairman, and I share not only the frustration but I would say outrage at what I have seen and heard. And if we are not even going to have the opportunity to talk to the Secretary, that is a very concerning thing.

I also think though, and to use one of the Chairman's charts to re-emphasize again how incredibly off they have been. I really question, with all of these numbers, whether we can believe at this point. We have not seen anything that was accurate that we could believe.

On the Sunday talk show, when Secretary Rumsfeld was asked what should the public know right now about a war with Iraq, what it would look like and what the cost would be, and he said the Office of Management and Budget estimated it would be something under $50 billion. It was said outside estimates say up to $300 billion, and he said baloney.

I would suggest that we are choking on that baloney, Mr. Chairman, the American people and the tradeoffs that we have had to make and the costs for our grandchildren and great-grandchildren for decades to come is extraordinary. It is hard to know where to begin on this, looking at all these numbers.

One thing, and then I have a couple of questions, let me just put in perspective in terms of choices. We are struggling, in the budget, to find a way to provide health insurance for every child in this country that does not have health insurance. I think everyone would agree, I think the American people would say, we ought to be starting from a premise that every child is uninsured ought to be able to get health care. Every parent ought to know that their children can have health care coverage.

That would cost $12 billion a year. That is a little bit more, not much, than 1 month in Iraq. So all of these numbers do have consequences, as we know, and I know the Chairman knows more that anybody else, stunning, stunning consequences when we are looking at over $500 billion. We are upwards now, Mr. Kosiak was saying, $737 billion overall in the global war on terror.

We certainly know that there are costs and that we need to address it, no question. But this is stunning to me.

The question I would have that relates to military preparedness. Those of us who did not support proceeding with this war have voted for the budget every year, which I have. It is because I do not want to send people to war and not let them know that we intend to have them have the equipment they need, have the training they need, and to have all of the support services they need so they can complete the mission, they can be successful, and they can come home safely.

I am astounded, Mr. Chairman, when you show a chart that says, again, that we are being told people do not have the equipment they need. That is the No. 1 question I want to ask the Secretary.

And I guess I would ask our panel, I am very grateful for all of your information. And I know it is job just to analyze and provide the information. But when we look at the fiscal year 2006 base budget, which was $410 billion for Department of Defense, this year we gave them a $29 billion increase when we look at base budget.

Next year they asking for $42 billion base budget, which is about a 9.6 percent increase in the base budget, which does not include Iraq, Afghanistan, or any of the costs that have been called emergency costs.

Why can't we provide people with equipment? Have you looked at any of the analysis? Have you broken it down at all in terms of the amount of dollars going for the equipment and support for our troops? Where is this going, Mr. Chairman? Where is the money going? It is not that we are cutting their budget. We are increasing their budget, almost a 10 percent increase for next year.

I am wondering if any of the panelists could speak to where the dollars are going that relate to making sure our troops have the equipment they need.

Mr. GILMORE. Well, about 60 percent of that base budget is for peacetime operations and maintenance and pay for military personnel. The other 40 percent is for researching new equipment, designing new equipment, and then buying new equipment, about $100 billion in procurement.

That procurement is mostly for new systems. And those systems such as, for example, the Joint Strike Fighter and Future Combat System when it starts being procured, they tend to enter the force very slowly and they are not really, for the most part they are not really relevant to supplying the troops in the field right now with equipment.

Those costs, the costs to repair that equipment and replace it have been in the supplementals primarily. And those costs have been growing very rapidly, as Steve Kosiak mentioned. In fact, in 2007, I think there is going to be about $32 billion for Army procurement in the supplemental and the bridge, and that compares with about $15 billion for Army procurement for these future systems in the base budget.

So the base budget is really funding, at least in terms of equipping troops, is funding the acquisition of these next-generation systems that are coming into the force relatively slowly. And so when you have troops in the field who are using equipment now and damaging it in the harsh environments, that money to handle those problems and replace that equipment has all been in the supplementals.

Senator STABENOW. So Dr. Gilmore, you are basically saying none of the Department of Defense base budget goes for making sure our troops currently have the equipment that they need; is that correct?

Mr. GILMORE. No, that is not really correct at all. That is not really what I meant to say.

The base budget funds the peacetime operations and the procurement of the next generation of systems. There is also, of course, there has been historically money in there for upgrading existing systems to keep them current. But a lot of that funding has migrated to the supplementals now, because there is a lot of equipment in Iraq that is being used. When they bring it back, they do not just repair it, they upgrade it.

So it is a mix of the two. But when you look at the investment program, it is mostly future looking, forward-looking, whereas the money in the supplementals is covering the costs of the damage and wearing out of the equipment in theater today.

Mr. ADAMS. Senator, if I could make just two points to supplement what Mike Gilmore has been saying, I think there are a couple of elements that need to be taken into consideration. One is that in the early emergency supplementals for the war, most of the money is going for supplemental pays and especially operations and maintenance. There is usually very little funding there for the acquisition of equipment.

So you have a gap between the technology modernization Dr. Gilmore is talking about and a recognition that you require some kinds of procurement and R&D work going on immediately because of the requirements of the troops in the field.

The other element is that when you see that gap what it often means, and it clearly meant it here, is very poor anticipation of what you thought you were going to run into. That is a broader characteristic of our planning for this conflict. But in this particular case, not anticipating body armor requirements, not anticipating up-armored Humvee capabilities, not anticipating the threat from IEDs in the field, have all led to a "scramble" effect—let's hurry up and find a program.

And of course, those things take time. When you put those programs in place, you have to put the acquisition system in place, as Senator Allard was saying. You have to find out what the technologies are that you need to combat IEDs. And so you are behind the curve.

So poor anticipation is part of this problem, as well.

Senator STABENOW. Thank you, Mr. Chairman.

I would just say in conclusion, if I might, that basically what you are saying is that we, because of the lack of understanding of what we were putting our men and women into, in terms of the situation and so on, and not planning and preparing and so on, we sent people into a situation without the equipment that they needed. And I think that adds insult to injury with all of this.

Thank you.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Chairman, I appreciate your Midwestern demeanor. But I have to be honest with you. I think and I hope the Chair will either author a joint letter or have a vote of this committee, that I hope would be a bipartisan vote, to demand the Secretary to come here.

This saddles the Nation's future. Iraq, our expenditures, saddles the Nation's future. And to not have the Secretary come here to make the case, whatever case that might be, about something that saddles the Nation's future, blows my mind.

So I hope and I would urge the Chair to do that, and I would be happy to join him in that effort.

Let me get past maybe the politeness of budget speak. First, I appreciate you having this hearing. But I want to start with a reference point that is not about money. It is about lives, 3,084 American lives. That is invaluable. There is no cost that can be associated with it. Twenty-three thousand men and women, sons and daughters of America, who are wounded in ways that affect their lives forever. And the costs, staggering. We have not included in this equation.

We spend about $8 billion a month in Iraq. We spend a $2 billion a week in Iraq. We spent $280 million every day in Iraq. We spend $11.5 million every hour in Iraq.

And we cannot get the Secretary of Defense to come here and justify that. That is outrageous.

But then again, I am not surprised, Mr. Chairman. This Administration has lied to the Congress and to the American people from the very beginning. They lied to us about weapons of mass destruction. There are none. They lied to us when the President landed on the aircraft carrier and said mission accomplished. Well, we are far away from that.

Lied to us when we were told we were going to be liberators and greeted as such. Lied to us when victory was just around the corner. Lied to us went in 2003 there were press reports where the Administration was downplaying the question of how much this war was going to cost, downplaying then $50 billion or $60 billion.

Now we have the escalation, and the escalation easily, as we have heard today, could very well be triple the projection.

Then, when we look at how much money we are spending, we had the Inspector General that this Administration wanted to eliminate, new report: waste and fraud in Iraq rebuilding projects. Cannot account for so many things, including $36 million in weapons that we cannot even account for. And we want more.

And we want a justification and say we want to give our troops everything in the field. Yes, but how can we know that they are even getting it.

And then we have another Business Week, military equipment, missing in action. New defense audit says the Pentagon has failed to properly equip soldiers in Iraq. Those that are there, before we send anybody.

Mr. Chairman, it is beyond belief. I appreciate all of witnesses' testimony. I just want to ask Dr. Gilmore, as it relates to some of what you said. You said the words it would be a historical—I think this is what you said—anomaly. That is a nice way to say they would be totally out of line with how much support personnel would be added per the troops that would presently be added in the field.

Is that basically what you are saying?

Mr. GILMORE. It would be out of—what the Secretary seems to be claiming, would be inconsistent what we know of Army planning and also what they have done in terms of the deployments in Operation Iraqi Freedom.

Senator MENENDEZ. And you said that means, I can only believe that means that they are willing to accept risks that they have not been willing to accept before.

What type of risks are associated with that?

Mr. GILMORE. It is the risks that they will not able to fully support the operational tempo that they will want to engage in, that they will have to constrain the operations of the forces in ways that they might not, they may not desire, otherwise desire.

But of course, this is all just speculation on my part. It is dangerous for me to speculate.

I think the simplest thing for me to say is I do not understand what the Secretary is proposing, and I have explained why I do not understand it based on what they have done and what we know they plan to do.

Senator MENENDEZ. I do not think it is so speculative if you have Army planning that says we generally provide X support personnel for the number of troops deployed, if that is your standard operating. Then you have a historical reality in Iraq. And then you deviate from that substantially. Something significantly is wrong.

My last question is in this escalation that they are talking about, you say that that means they would have a downturn in August; is that correct?

Mr. GILMORE. That is the way we modeled it based on what we have heard.

Senator MENENDEZ. Mr. Chairman, every briefing we have received says that they will finally be at full force in May.

That means in 2 months we are going to do everything we need to do? We are going to secure Baghdad and we are going to start down-forcing in August?

You know the part of the Nation that I come from, we were born, but not yesterday. And the bottom line is this is outrageous. No one can believe the Administration, as you so aptly said, has been unwilling to except timelines for anything. And yet for this purpose, in order to hide the real costs of the escalation, we are going to have timeline that suggests that in August we are going to actually reduce forces. It is just not going to happen.

Mr. Chairman, we need the Secretary of Defense here. We need answers. This is overarching.

Chairman CONRAD. Let me just say that the President said, as recently as yesterday, no timeline. It seems to me very clear there is a timeline associated with this, when you overlay the budget numbers with what he said.

Let me just say, the discrepancy between the testimony of the witnesses today and what the Administration is telling us is so stark that I understand why the Secretary does not want to come up here and testify. But that just is not acceptable.

We have gone through this war for 4 years and no Secretary of Defense has come before this committee to testify. I think it is abundantly clear why not, because they have played hide the ball with this committee, with the Congress of the United States, with the people of this country on the true cost of this war.

It is no longer arguable. It is very clear.

I am going to ask this committee, I am going to circulate a letter and ask, on a bipartisan basis, that we write to the Secretary, insisting that he hold to his commitment, his previous commitment, to come before this committee next week.

Let me just say, at the same time, I am researching sterner measures and we will not go further with that now until we find out what that research discloses. But it is not acceptable to this committee to have the Secretary of Defense refuse to come before this committee and defend these numbers.

Senator SANDERS.

Senator SANDERS. I am glad to hear that, Mr. Chairman. I want to go on record as concurring with the Senator Menendez.

But frankly, I am not surprised that they are not here. I do not blame them. If I had their record of distorting the costs of this war, if I had their record of how they misled the American people into this war, if I had their record in terms of being as unprepared as they were to fight this war, I also would not want to come before the United States Congress or this Budget Committee.

But I do have to say, Mr. Chairman, the fault is not totally with them. The fault is with us. We have abdicated our constitutional responsibilities on this issue. We do not have to beg them to continue to come. If they do not want to come, I tell you what I think the assumption is. The assumption is that cannot defend their figures because they are dishonest figures. They are not accurate. And I think that you should say to them, and I would hope the letter would suggest, that we assume that you have overstated overstated what you need. We have going to significantly underfund your request unless you tell us otherwise.

If you do not have the courtesy to come before this committee, we will not take you seriously.

So I am not just blaming them. I am blaming us. And that gets back to the whole broader issue of how we bring our troops home as soon as possible and the need to begin to use the power of the purse to do that.

Mr. Chairman, I just received a letter from Vermont and I have the feeling that every member of this committee has received similar letters. This is an article from a newspaper in Central Vermont dealing with a school board meeting of a very small high school in Plainfield, Vermont, Plainfield and Marshfield, Vermont.

And I quote a young person, a kid in the school. The kid says "The changes in the school budget, the cuts in the school budget, scare me more than I could have ever expected. I cannot imagine getting an education at Twinfield High School without the honors English class I took my junior year and many other scholastic programs that are being compromised."

In other words, in Central Vermont, all over my State, all over America, kids are not getting the education that they need. They cannot afford to go to college. Our child care and Head Start programs grossly underfunded.

And yet the Department of Defense comes in with huge budgets to fight a war that we never should have fought in the first place.

I think, Mr. Chairman—

Chairman CONRAD. Let me be clear to the audience the rules of the Senate. There can be no expression by the audience during the functioning of this committee.

If anybody violates those rules, they will be removed from the hearing room. Let me just make clear, that it is rule of the Senate and it will be enforced in this committee.

The Senator may proceed.

Senator SANDERS. I just find it a very tragic that when our children need support so that we can end the shame of having the highest rate of childhood poverty in the industrialized world, there is no money for them.

Senator Allard mentioned a few moments ago about the situation of our veterans. I know in Vermont, I do not know about Colorado, there are waiting lists, waiting lines for veterans to get into VA hospitals.

Somehow, we do not have enough money to take care of our veterans. We have 47 million Americans who have no health insurance. The problems facing the middle-class and working families of this country are enormous.

And somehow when we need money to fund those needs, we do not have the money. But when the President comes in with a huge military budget to continue a war that should never have been fought in the first place, apparently this Congress is giving that serious consideration.

I think that that is wrong. I think, Mr. Chairman, we should use this Budget Committee to rethink our national priorities. I think we should use this Budget Committee to begin the process of beginning our troops home as soon as we possibly can.

Thank you very much, Mr. Chairman.

Chairman CONRAD. I thank the senator.

Let me just indicate that we will be circulating a letter to committee members with respect to asking once again that the Secretary come before this committee. He had previously committed to do so. I think it is essential, given the extraordinary costs associated with these requests the Administration has made, that the Secretary himself come before this committee. I do not think that is an unreasonable request. He had previously agreed to do so. It is just unacceptable for him to back out.

I can tell you, for too long the Secretaries of Defense have been bucking this to somebody else. This committee, I think, deserves to hear from the Secretary of Defense. The discrepancy between what he is saying the cost will be and the professional testimony of the nonpartisan Congressional Budget Office about what this cost will be are so sharply different that we simply must insist that the Secretary of Defense come before this committee and explain his intentions.

That is something we are going to insist on. I hope that message is received.

I again want to thank the witnesses and we appreciate very much your participation in this hearing.

[Whereupon, at 11:47 a.m., the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 2008 BUDGET PROPOSAL

WEDNESDAY, FEBRUARY 7, 2007

UNITED STATES 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, Murray, Wyden, Feingold, Menendez, Sanders, Whitehouse, Gregg, Allard, Enzi, Bunning, Crapo, and Ensign.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. We will bring the hearing to order.

Let me indicate that Senator Gregg, of course, because of events on the floor, will be there for at least some part of the morning. Senator Allard will be filling in ably for him, and we appreciate his doing that, in light of the events that have developed over the last 24 hours.

We want to welcome Director Portman, the head of the Office of Management and Budget, to the Senate Budget Committee. I am appreciative that the Director has taken his time to be here and that we can have a discussion on these critically important issues facing the country.

I have high regard for Director Portman, both personally and professionally, and we very much appreciate his public service and look forward to his testimony today.

Let me just start with concerns we have about the budget, and these are things that we can discuss during the hearing. As we look at the budget we see a number of things that are left out, full Iraq war costs beyond 2008. In saying that, I also want to acknowledge and commend Director Portman for pressing to get at least a realistic war cost put in for 2008. I do not think that would have happened without his pressing the issue, and we appreciate it. It was certainly a step in the right direction.

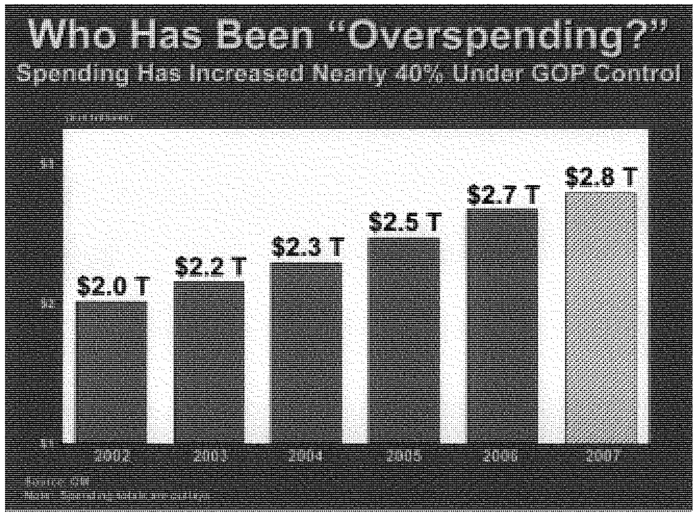
We also note that while this is a 5-year budget there is only money for alternative minimum tax reform for the 1-year, so it leaves out detail past that for the alternative minimum tax.

It also leaves out, the budget leaves out discretionary spending levels beyond 2008. So this is a 5-year budget, but we only have discretionary spending details for the 1-year.

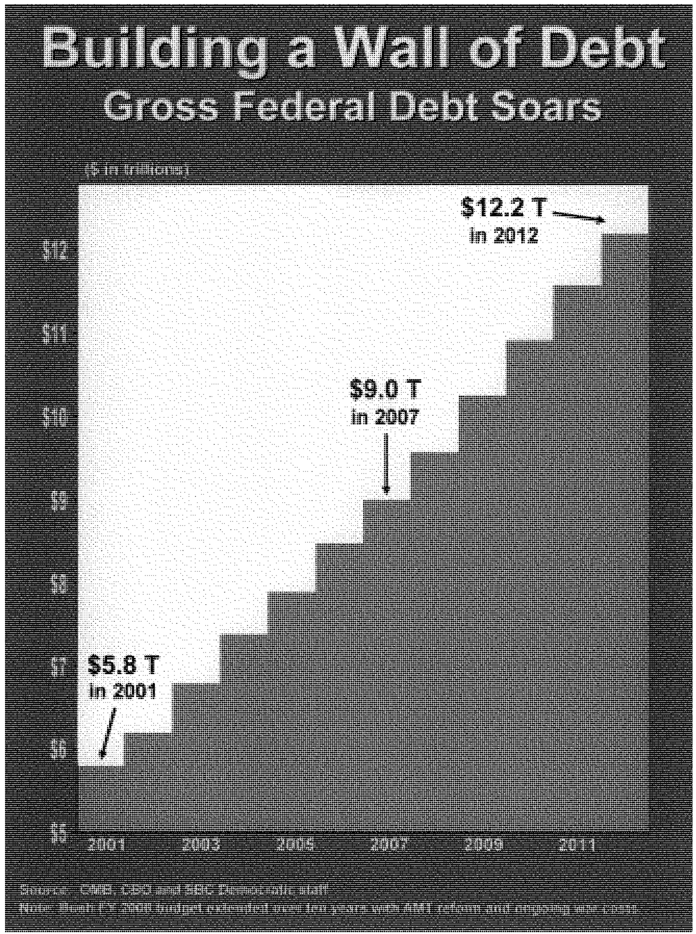
Let me go to the next—one of the, I think, serious issues that we have to confront as a Congress and a country is the revenue side of the equation. Our friends on the other side only want to focus on the spending, and while I would completely agree we have to be disciplined on the spending side I think we also have to look to the revenue side of the equation.

Our friends on the other side of the aisle point to the rapid revenue growth of the last several years, and indeed there has been rapid revenue growth the last several years. But they neglect to mention what happened before then. They neglect to mention that we have had revenue stagnation for 6 years. In fact, revenue went down after the last peak we had in 2000, where we had revenue of just over $2 trillion, revenue was below that for 2001, below for 2002, 2003, 2004, 2005. Only in 2006, on a real revenue basis, did we get back to the revenue of 2000.

Let's go to the next slide, if we can. So revenue was down but spending was up. In fact, under the Administration's spending plan, the spending side of the equation increased by 40 percent. So revenue was down, spending was up. The consequence is the debt exploded.

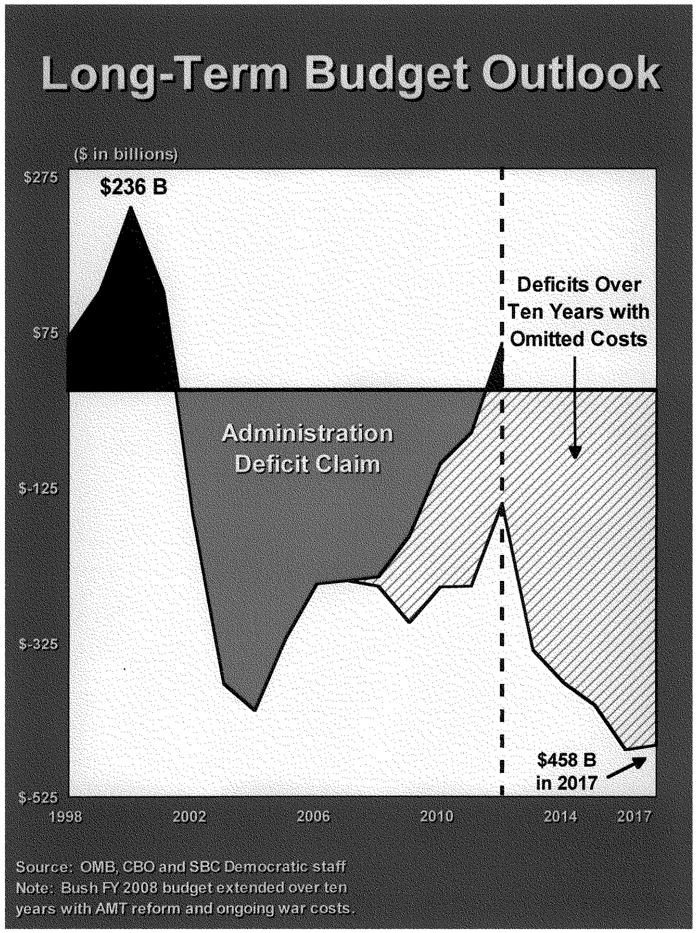


Let me have that slide, if we can. Here is what happened to the debt of the country. We have a $3 trillion increase in debt during this Administration. And over the next 5 years we are anticipating, if the President's policies are adopted, another $3 trillion of debt.



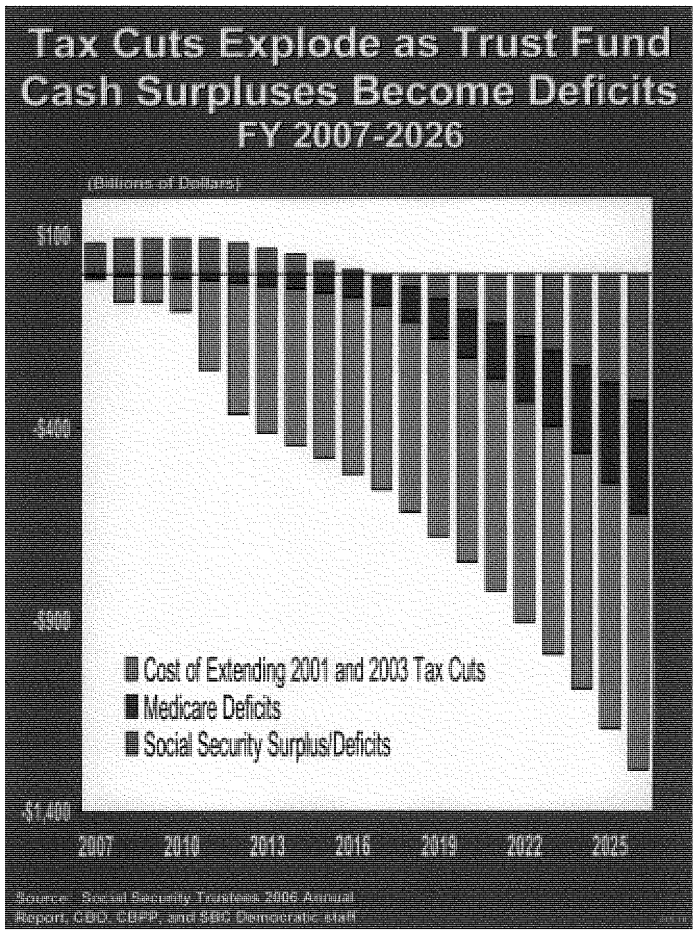
Let's go to the next slide.

The President, in this budget, advocates a number of spending cuts. But he also advocates additional tax cuts, making the current tax cuts permanent. And with the other omitted items, if we look at the 10-year outlook rather than just the 5-year outlook—because the 5-year outlook we see some improvement. But then if we put back the omitted items, we see the fiscal condition turning back on us, back into deeper deficits and more debt.



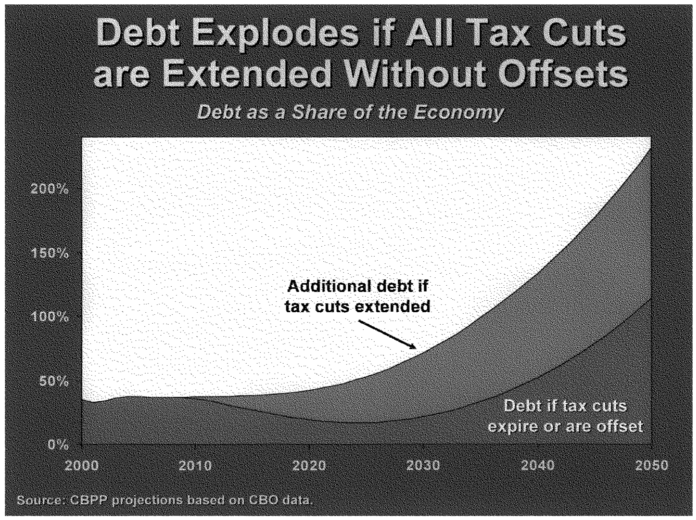
Let's go to the next slide.

Perhaps most serious, and I think all of us share the understanding of our long-term situation is unsustainable. And when I look at the President's budget, he makes that situation worse because, in making the tax cuts permanent, the cost of those tax cuts explode at the very time the trust funds of Social Security and Medicare go cash negative. And the combined effect of all of this is to take us right over the cliff.



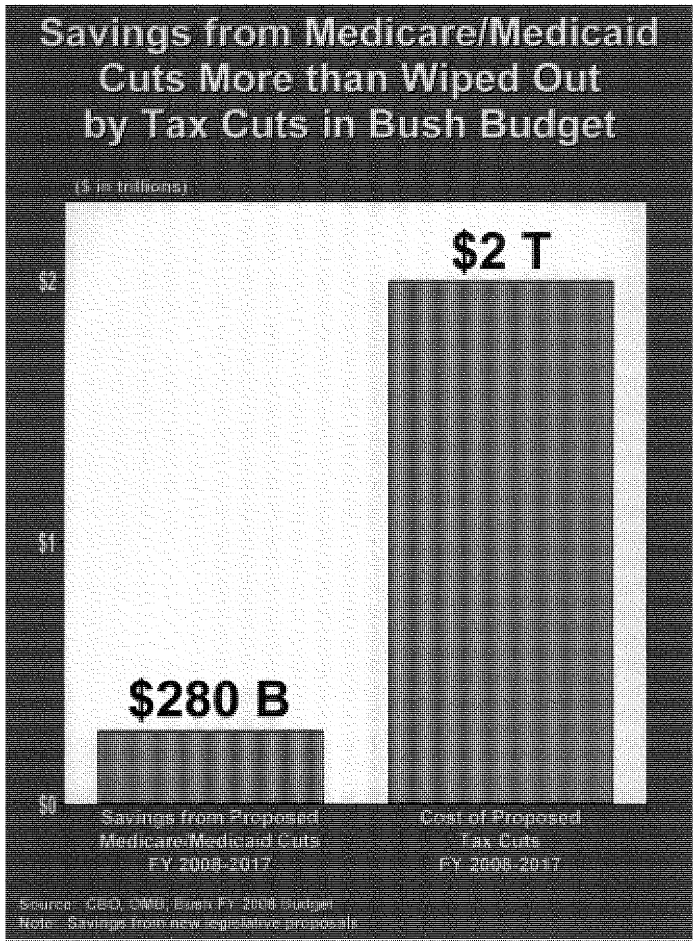
That cannot be the fiscal future of the country. Let's go to the next slide.

This next chart shows what happens if the tax cuts expire or are offset. That is the green part of this bar. If they are not paid for, if they are not offset, here is what happens to the trajectory, the fiscal trajectory of the country. It is a trajectory of rapidly rising deficit and debt, and at the worst time, right when the baby boomers are retiring.

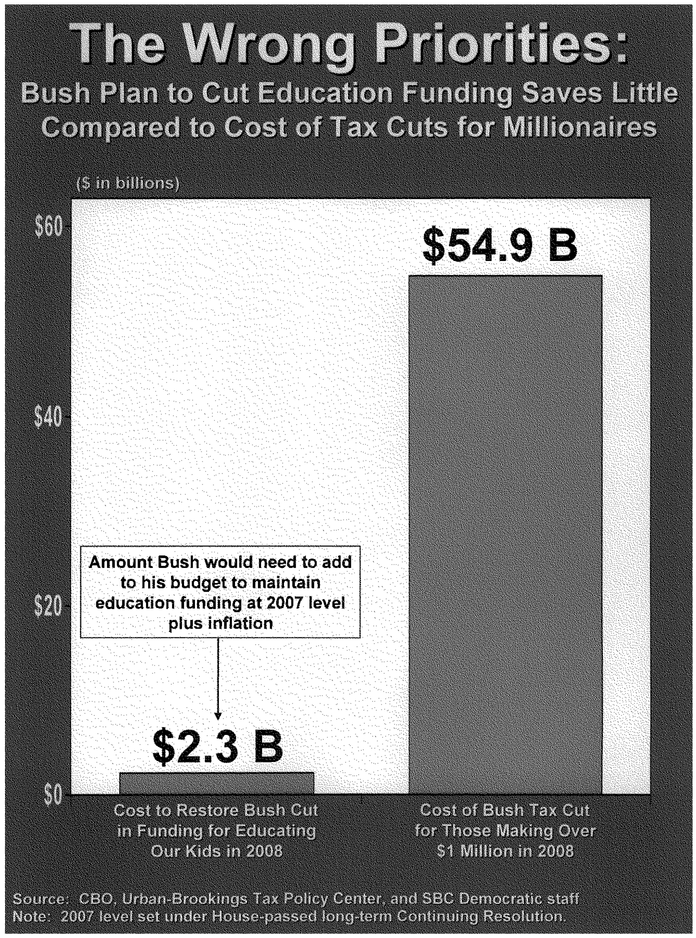


Let's go to the next slide.

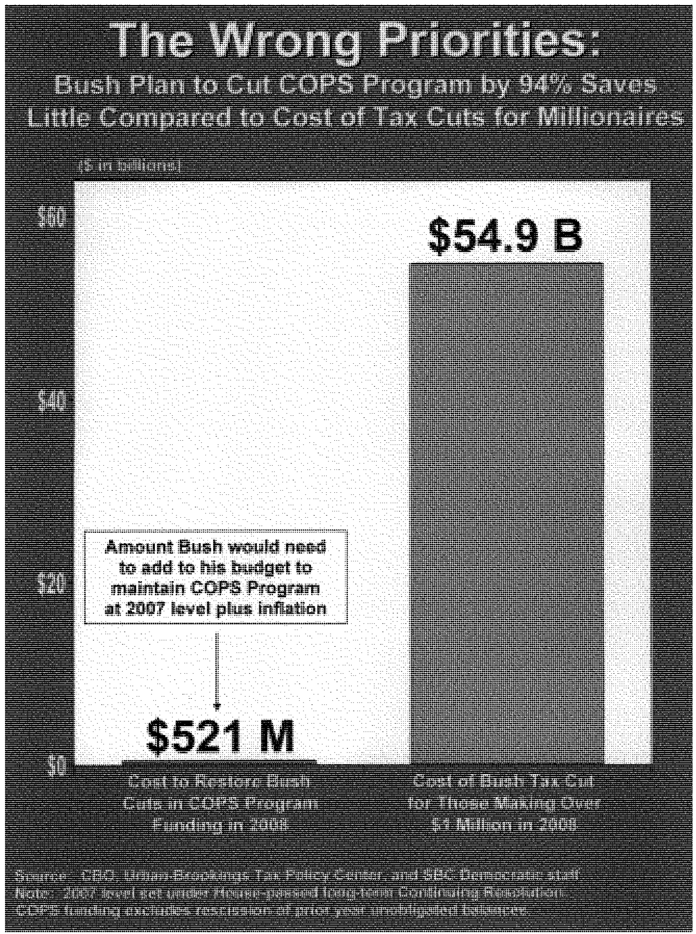
I look at the President's budget and he has savings in Medicare and Medicaid which, over a 10-year period would equal $280 billion. But the cost of the President's tax cuts during that same time are $2 trillion, $2 trillion when we add debt service into it.



And then there are the question of priorities. We look at the President's budget. For 2008 the cost of tax cuts for those earning over $1 million a year for that year alone is $55 billion. The President says cut education $2.3 billion. These are not priorities that on our side we share. We do not think that is the proper balance for the country.

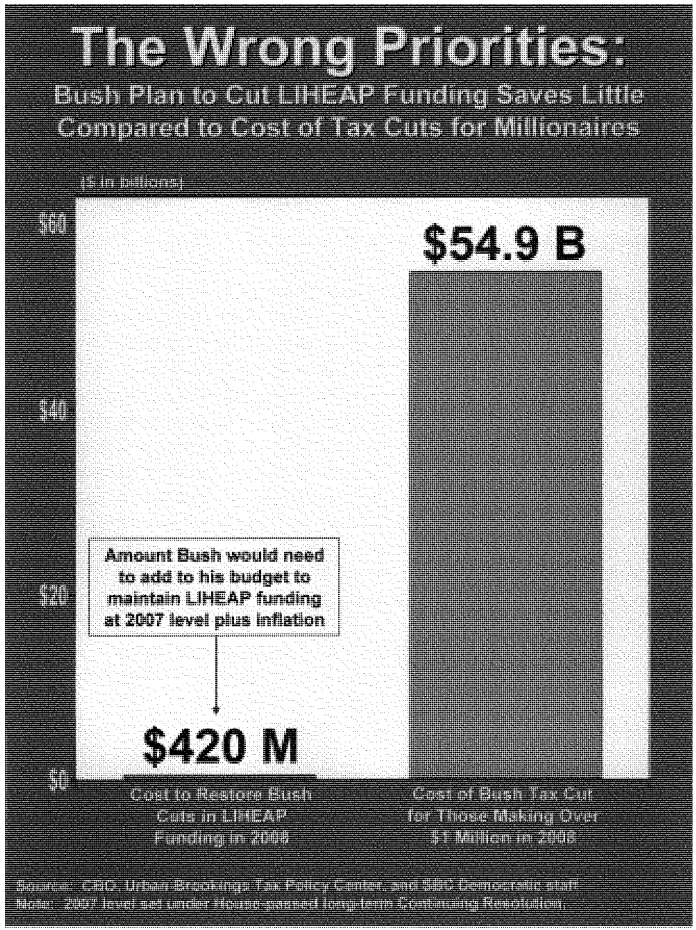


We see the same thing with respect to the COPS program. The President's budget proposes cutting the COPS program 94 percent. It would take $520 million to restore the COPS program for 2008. Again, that same year the President is advocating continuing tax cuts for those who earn over $1 million a year of $55 billion, 100 times as much.



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

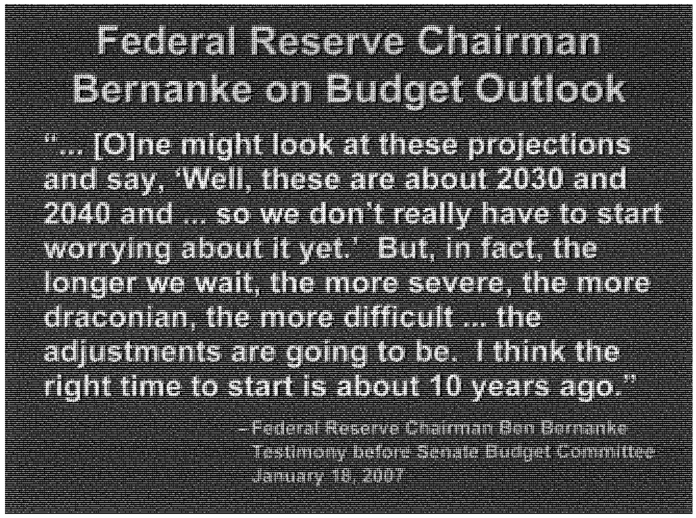
LIHEAP, low income heating assistance, the President's budget proposes cutting that nearly 20 percent. It would take $420 million to restore it. Again, the comparison is the tax cuts for those earning over $1 million a year.



I would say this is especially sensitive in my home State. The other day it was 46 below in North Dakota. We have a real understanding of the need for heating.

This is what Chairman Bernanke told us. And what I want to focus on in my time is the long-term outlook because we have differences on this 5-year budget. Those are differences I believe we could bridge. I am far more concerned about where this is all headed in the long-term.

This is what Chairman Bernanke told us: one might look at these projections and say they are about 2030 and 2040, we really do not have to start worrying about them now. But in fact, he said, the longer we wait the more severe, the more draconian, the more difficult the adjustments are going to be. I think the time to start, he said, is about 10 years ago.



That puts this discussion where I think it needs to be.
With that, I call on Senator Allard.

OPENING STATEMENT OF SENATOR ALLARD

Senator ALLARD. Good morning, Ambassador Portman.

I would like to welcome you to the committee on behalf of Senator Judd Gregg and myself. As was explained, Senator Gregg is tied up on the floor of the Senate. We anticipate him joining the committee later on.

Mr. Chairman I wonder if I might provide a further explanation of the first chart that you pulled up. Do you mind if we used your first chart there?

Chairman CONRAD. I do not mind at all.

Senator ALLARD. Thank you.

It would be the first chart that he pulled up.

What I would like to point out on that chart, he talked about the problem with the first 6 years. But if you remember, 2001 is when we had 9/11, and then shortly after that we had the technology bubble break, the Internet bubble, however you want to describe it.

And 2003 is when we passed the economic growth package that was signed by the President. Look what has happened to revenues after that economic growth package. Every year after that they have increased. I just thought that we needed to have that further explanation.

Chairman CONRAD. Let me just say, the first and biggest round of tax cuts were passed in 2001, and you can see revenue went down.

Senator ALLARD. Well, 2001 related—we dealt mainly with 9/11. We got to 2003 is when we passed the economic growth package.

Chairman CONRAD. No, no, no, 2001, let's be factually accurate with people. If you are going to use my chart, let's be factually accurate. The biggest tax cuts were in 2001. You see, you put those tax cuts in effect—in fact, your side told me you are underestimating, Senator, the effect on growth. We are going to have much more revenue.

Well let's see. We did not have more, we had less revenue in 2002, less revenue in 2003, less revenue in 2004, less revenue in 2005.

Senator ALLARD. Let me make this point, if I might. In 2003 that economic growth package that we passed was a growth stimulant package. Those cut tax cuts were designed to encourage the economy to grow, and they have been successful.

Now we have had discussions in the past that not all tax cuts stimulate the economy equally. There are some that do more than others. And I just wanted to make a point that those we had in the 2003 package has made a difference, and I think that chart reflects it.

I do want to go ahead and make some formal comments on behalf of this side of the aisle.

This, of course, is an annual exercise in that once a year the President submits and Congress receives a comprehensive budget for the United States Government. And every year there will be people who criticize and say the budget is dead on arrival.

And yet, regardless of who controls the White House and who controls the houses of Congress, the legislative branch pivots off the President's budget and is largely reactive.

The President's budget, regardless of which president and which OMB draft, becomes the memo for the meeting and drives all other action.

This fiscal year 2008 budget proposes some notable changes and reforms. First, it is clear that the President's economic policies have been a major success and have led to recovery from the recession caused by 9/11 attacks and the burst of the Internet bubble. The economy is growing at 3.5 percent and is now in its fifth consecutive year of expansion.

Since 2003, over 7 million new jobs have been created. The President's policies of holding down taxes and stimulating private sector growth resulted in a continuing rise in Federal revenue collections. Federal revenue collections are over their historic average, and just last month once again showed that everyone's estimates—that is OMB's, CBO's, and outside experts, have been too cautious. For the first 4 months of this year tax collections were over 9 percent above this same period last year.

The President's budget gives priority to keeping taxes fair and low and by allowing Americans to retain their hard-earned money. The President's tax policies have been a major success and this budget keeps tax relief in place and proposes additional changes such as ensuring that American companies invest in research and development to improve our economic competitiveness.

Second, the budget includes an annual estimate in 2008 for the cost of the global war on terror and support of our American men and women in Iraq and Afghanistan. Thank you, Director Portman, for listening to the Congress and including a requirement that we can now review.

In fact, the 2008 President's budget clearly and unequivocally puts a priority on defending our Nation. This is the core duty of our Federal Government. The President's budget supports our military personnel and grows our force structure. It provides ample operation and maintenance resources so as to not allow a hollow military to reoccur. It provides for procurement of modern weapons systems and research and development to stay ahead of any threat or foe.

Third, the budget tackles the long-term entitlement bow wave that threatens to undermine our economy and our children's future. The budget goes in specific programmatic detail and makes program adjustments to rein in some of the uncontrolled growth of mandatory programs, $61 billion in net mandatory program savings are proposed.

And fourth, the budget continues overall spending discipline, especially for non-security programs.

I thank the Chairman and I yield my time.

Chairman CONRAD. Thank you, Senator Allard.

We will go now to Director Portman or Ambassador Portman, both titles apply. Welcome to the committee.

STATEMENT OF HON. ROBERT J. PORTMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. PORTMAN. Thank you, Mr. Chairman, very much. And I want to also thank other members of the committee who are here this morning, including Senator Allard. Thank you for filling in. And to Senator Murray, Senator Bunning, Senator Feingold, Senator Sanders.

I look forward to the opportunity to engage in some of the issues that were raised by the Chairman and ranking member this morning, including that chart, which we will see again, I am sure, and I do have some comments about that.

It is good to be before the committee again and have the chance to talk about this budget. As Senator Allard said, it is our fiscal year 2008 budget. It is a 5-year budget building on the reduction of the deficits over the last 2 years of $165 billion. The President's 5-year 2008 budget continues to reduce the deficit every year and achieves balance by 2012.

We do so while keeping taxes low, but also meeting our Nation's priorities. Although we will have differences on how to achieve balance, as Chairman Conrad said, I believe we have an opportunity to bridge our differences with regard to the short-term outlook. And our sincere hope is that this budget helps provide the basis for us to work together across party lines to achieve balance in the short-term, but also to prepare us better for the long-term. Because I agree with what Chairman Conrad said with regard to our more difficult fiscal challenge.

I believe this is a realistic budget. Instead of painting a rosy scenario on revenues, I believe it is cautious. We can talk more about that in a moment.

We have also responded, as Senator Allard and Senator Conrad acknowledged, to congressional concerns about showing more war costs. For the first, we have included these supplementals in the budget, as you know. We have done it in a more transparent way. All of these war costs, by the way, are calculated as part of the reduction in the deficit every year and the balanced budget in 2012.

We have changed our projections a little bit from past years. We have gone from a freeze, or some years a cut, to a slight increase in non-security discretionary spending. And we have done that throughout the budget window.

It is consistent with what Congress and the President have actually enacted for the past few years, by the way. It is below inflation. It is 1 percent. It is also, by the way, just about where we are on the continuing resolution this year.

You will also see we have eliminated some policies that show budget savings but are unlikely to materialize because of congressional opposition. One that I have heard from members of the committee about is the TSA user fee, as an example, which is $1 billion. We did not include that in the budget this year.

I have had a lot of conversations with Chairman Conrad and Senator Gregg, and others on this committee, about our biggest fiscal challenge. And it is this unsustainable growth in the entitlement programs, important programs, Medicare, Social Security, Medicaid. I will address this further in a moment but the progress we are making in getting our fiscal house in order in the short term must not distract us from this longer-term challenge.

In this budget, as you will see, we have proposed some sensible reforms, primarily in Medicare, that are less than a 1 percent reduction in the annual rate of growth over the 5-year period and over the 10-year period, but they do represent an important step in beginning to reduce the unsustainable growth in these critical programs.

I hope we will be able to begin addressing these unfunded obligations through the budget process. I also believe that Senator

Conrad and Senator Gregg's idea of a bipartisan working group has promise, and I commend them for their personal commitment to addressing these broader entitlement challenges.

While restraining spending overall, the President's budget also provides resources for key priorities. As Senator Allard said, it increases funding for national security to combat terrorism and protect the homeland. It includes new policies to address issues of concerns to America's families including educating our children, access to affordable health care and reducing energy costs. On the whole we have attempted to give you a credible and more realistic plan to try to maximize our chances of working together to achieve balance over 5 years.

Over the past 2 years we have been able to reduce the deficit by about $165 billion. We have been able to do it for two primary reasons. One is a strong economy. We have been blessed with a strong economy that has generated record revenues the last couple of years.

Second, we have done a little better job of restraining spending, and Congress deserves some credit for that, especially in the nonsecurity spending, keeping it under inflation for the past 3 years. I talk about that a lot publicly. The press very seldom pick up on that point, but it happens to be true.

It is exactly these elements, the solid economy and reasonable restraint on spending, that can now lead us to balance, working together.

As you can see from this first chart, because I will have a few of my charts, too—not as many as Senator Conrad. I am building up. Maybe next time I come before you I will have as many.

The budget reduces the deficit every year and results in a surplus in 2012. In fiscal year 2007, this year, we project the deficit will decline to $244 billion, which is a reduction, by the way, of $95 billion since our last estimate in July of 2006.

The deficit in 2008 falls again to $239 billion. As you will see from this chart, the 2008 deficit is 1.6 percent of our economy which I believe is the key measurement of the deficit, percent of GDP, because it shows the impact of Government borrowing on economic activity. This projected 2008 deficit, by the way, is lower than 18 of the past 25 years as a percent of our economy.

The deficit then continues to decline each year, both in nominal terms and as a percent of the economy, until we reach a budget surplus of $61 billion in 2012.

You will recall that 3 years ago the President established this goal of cutting the deficit in half from its then projected height in 2004. At the time, a lot expressed skepticism that this goal could be met, including some members of this committee. But it was achieved. We achieved that goal together. We achieved it back in September, 3 years ahead of schedule. We will now build on that success and again work with this committee and others to come to balance over a 5-year period.

To keep the economy vibrant, we need to continue the pro-growth economic policies that have been in place and help fuel the economy, and therefore the revenues. The 2008 budget continues to support growth, innovation and investment by making permanent the tax relief that was talked about earlier that would otherwise expire in 2010. As you can see from this chart, and it is a very interesting chart to respond maybe to one earlier—

You might want to just hold it up. Senator Conrad has his held up. I kind of like that.

[Laughter.]

Mr. PORTMAN. Since the tax relief took effect in 2003, you see in 2001 there was a big reduction in revenues. That was not because of the tax relief. Primarily it was because of the recession. When there is a recession, our revenues go down.

Senator Allard is right, 9/11 hit, the bubble burst in the stock market and so on, but when you have a recession this is what happens. It was the most shallow and shortest recession we have had in our recent history, but we did have a recession and revenues go down.

The 2001 tax relief was fully implemented in 2003. In 2003 there was additional tax relief, as you know, on the investment side, primarily capital gains relief, dividend relief. Amazing correlation there, you see between the 2003 full implementation of the tax cuts and the change in business investment, which is the green line, and the change in jobs, which is the purple line. Dramatic increase in jobs, 7.4 million new jobs since that time, a big increase in business investment, productivity, and paychecks are growing.

This is what we want to be sure continues.

After 2003, the economy not only strengthened, but Federal revenues also surged, as I said earlier, in fact hitting record revenue levels. The President's 2008 budget uses 5-year economic projections that are in line with those of outside experts. As you can see from this chart, we assume GDP growth will average about 3 percent over the budget window. The first quarter of this year, as you know, was 3.5 percent, just reported last week.

But our projections over that 5 years closely track those of the so-called Blue Chip projections, which is a compilation of various outside forecasters. This year we have a 2.7 percent projection. I said earlier I believe our revenues are cautious. So is our GDP growth, 2.7 is relatively low. Most outside forecasters are now well above 2.7, partly again from the information that we have received since our budget was put together.

As you can see from this next chart, with solid economic growth our total receipts are now 18.5 percent of our economy. That is slightly above the historical average of 18.3 percent as a share of the economy. We project receipts remain at or above this historical average, by the way, for the 5-year period.

So the notion that we are under-taxed relevant to again our history is just not accurate. In fact, we are already over the historical average. Yes, we dipped down in 2001 and 2002. That is absolutely right. But we are back up, not just to the historical average but a little above it. And our projections are we stay there during this entire 5-year period.

I termed our revenue forecast as being cautious for this fiscal year. Our forecast for this fiscal year is 5.5 percent growth in revenues. And then, over the 5-year period our average is 5.4 percent per year for 5 years.

This is, of course, below the 40-year historical average, which is 7.6 percent. It is also well below the dramatic 11.8 percent increase of last year and 14.5 percent increase of the year before.

That is one reason I call it cautious, but in fact it is below the actual first quarter numbers that are now in, which is 8.2 percent in the first quarter. As some of you know, CBO reported yesterday on some January figures that are even higher than that of the first month of the next quarter.

As in the past, our revenue projections are being produced by the career professionals at the Office of Tax Analysis at the Department of Treasury. We have chosen to use them. You do not require us to, but we have chosen to use those projections.

I will also say, as was the case in the past 2 years, we may well find that our revenue projections are low, and thus our 2007 deficit projection is high. I want to say that now because I remember what happened last July when we came out with our reduced projection of the deficit. And people said gee, you lowered expectations when you put the budget out.

I am not trying to lower expectations. I am giving you what our tax professionals are saying, career professionals. I think they are very cautious. I think that is just where we have been the last 2 years and we are likely to be there again this summer when we do our mid-session review.

Even with his cautious forecast on revenues, the budget demonstrates we can achieve balance by 2012 and do it without raising taxes. In addition, we plan to more effectively and efficiently collect the taxes owed through an unprecedented effort to close the tax gap. This is something that Chairman Conrad and others have talked about a lot.

It is a problem. And we approach the problem in two ways. First, we improve the effectiveness of IRS's activities with a $410 million package of new initiatives to enhance enforcement and taxpayer service and to improve IRS technology, all focused on compliance.

Second—and by the way, relying on standard conventions, we do not show any additional receipts from this. We do not score these additional resources to the IRS in our budget. That is the way CBO has traditionally done it, that is the way we have traditionally done it.

This is increased compliance. I believe it will result in increased revenues. We can talk more about what some of those figures might be, but it is not in our forecast.

Second, we include in the budget 16 carefully targeted tax law changes that promote compliance while maintaining that critical balance between taxpayers and taxpayers' rights on the one hand, and our shared interest in collecting the taxes due.

These changes in the legislative side are estimated to raise $29 billion over a 10-year period, which as those of you know who follow this tax gap is a relatively small part of the tax gap, but it is scored in our budget as raising revenue because these are specific legislative changes.

As noted, the 2008 budget proposes to hold the rate of growth for non-security to 1 percent. Again, we think that is fiscally prudent and also realistic. Congress and the President have done a better job at that. You all have done a better job on the non-security side of domestic discretionary spending. In fact, the growth over the last 3 years is about 1 percent. It is about 1.2 percent the last 3 years on average, including this year.

Again this year, the House just passed a continuing resolution that you all are going to look at, I understand this week and next week, that is at about the same level. We believe we can address our Nation's top priorities at this level of funding. You have shown we can do it and our budget does just that.

Within discretionary spending, the Administration closely examines programs to determine whether it is a priority or not, whether it is effective, whether it is producing intended results. Based on these thorough reviews the budget proposes to terminate or reduce 141 discretionary spending programs which save about $12 billion. These reforms will help us reduce the deficit, but it channels resources to higher priorities and more effective programs.

We are able to make these judgments as to how taxpayer dollars are spent, in part, because of tools that we have developed working with this committee, the Homeland Security Committee and others on the President's Management Agenda. I encourage you to look at our analysis of these programs.

Last year to ensure greater Government accountability, we launched this new website called ExpectMore.gov. This site includes information for taxpayers on the programs that have been assessed for effectiveness using what we call the PART, Program Assessment Rating Tool. With this website, Congress and the public now have an unprecedented view into our Federal programs, which ones work, which ones do not, and what we are doing to try to improve them. It is another way we are providing greater transparency, holding ourselves accountable and demanding results.

The new and improved version of this website was launched yesterday. We now have program level information about the performance of nearly 1,000 Federal programs representing 96 percent of Federal Government spending, about $2.5 trillion of spending. I urge members, I urge their staff, I urge any viewers that might be watching, to checkout ExpectMore.gov. It is an interesting view into your Federal Government and how we made some of our decisions.

The President's 2008 budget also outlines a comprehensive series of budget reforms that will help improve fiscal restraint, transparency and accountability. This committee has taken the lead on a number of these.

Legislative line item veto is, of course, one. I commend Senator Gregg for his efforts recently in leading a bipartisan effort that resulted in a close vote, but a majority vote, of the Senate to move the legislative line item veto through the Senate. The House actually passed such a bill last year, as you know, by a 247 to 172 margin, so a bipartisan effort in the House. By allowing Congress to take a second look at legislation through the process, I think it will help. I think we can work together to help reduce unwarranted earmarks or other wasteful and unnecessary spending.

I also think it is complementary to the key reforms to the earmarking process that you all have just been through. The President has some additional ideas there to take earmarks out of report language, put them in statutory language so you actually vote on them, and so you have an opportunity to strike those you think are inappropriate. The President also believes we ought to reduce those earmarks by half.

Our budget also proposes discretionary spending caps. In effect this expands PAYGO from no new spending in the mandatory side unless it is paid for, to the discretionary side as well. We also have additional proposals with regard to mandatory spending. They are specific, as I mentioned earlier, but also some process reforms that get to not just new spending in mandatories but the existing problem that we talked about earlier.

Our budget shows how we can work with you to achieve a balanced budget by 2012, but that accomplishment will be short lived without addressing what Senator Conrad has talked about, which is the long-term challenge, the unsustainable growth in the entitlements.

As you can see from this chart, mandatory spending is overwhelming the rest of the budget. In the space of four decades, we have gone from about 26 percent of our budget to over half of our budget devoted to these programs, and it continues to grow.

As the next chart shows, the trends are just not sustainable. Senator Conrad has a good chart where he talks about that, as well. Under this chart what you will see is that by 2040 spending on these three programs and the debt that is attributable to those programs crowds out all other Federal spending. So there would be no spending for education or homeland security or defense.

It seems to me that there is now nearly universal bipartisan agreement that the unchecked growth of these programs does provide real long-term threats to beneficiaries, to our Federal budget, to our economy.

We now face, by the way, a $32 trillion unfunded obligation in Medicare alone. That is over a 75-year period.

Our choices are pretty stark: massive benefit cuts, enormous deficits, or huge tax increases. Unless we act. And we can act. And we can act to make relatively small changes in these programs now to avoid that happening.

The balanced budget is important, in part, because it positions our country better to address these looming fiscal challenges. But our 5-year budget proposal also makes an important down payment toward sensible reform of these mandatory programs, reducing spending growth by $96 billion over 5 years.

Again these reforms are primarily in the Medicare program, but also in Medicaid and other programs. The proposals are similar in character to those this Administration has offered in the past, also to what the previous administration has offered, also to what a lot of Members of Congress have offered, and what we did together back in the 1990's.

To put these reforms in some context, you can see from this chart, the size of our budget proposal is a lot smaller than what we did on a bipartisan basis with divided government back in 1997, the last time we attempted to achieve balance together.

Although an important first step, the savings in this proposal, as you see here, would only reduce the unsustainable annual growth rates of mandatory spending by less than 1 percent. Back in 1997, it was 2.8 percent.

What we are proposing is also less than what we did in 1990 with OBRA and 1993 with OBRA, and some of you were involved in those efforts.

Specifically, over 10 years the annual rate of growth in Medicare would be reduced under our proposals from a projected 7.4 percent annual growth to 6.7 percent annual growth. So it is still a very healthy increase. Of course, more than double inflation, maybe triple, and considerably higher than domestic spending.

However, while these proposals deliver relatively small savings in the short-term, the effects that build over time are more substantial. The challenges that we face are great and the changes that we are proposing are relatively small compared to the challenge in the first five and 10 years, but over time they do help reduce the unfunded obligation of the program, by about 25 percent actually over the 75-year analysis of the unfunded obligation.

Frankly, under our policies, we can achieve a balanced budget within this 5-year window without any of these mandatory changes. So the budget we are giving you today, the proposals you see, we can get to balance, we can show you how we can get to balance with a surplus in 2012 without making any of these changes on the mandatory side. That would be the wrong thing to do. We would only be digging a deeper hole by ignoring it for another year.

Balance is not coming at the expense of our Nation's commitment to seniors and low-income Americans. Quite the opposite. We have to begin to reform these programs now in order to protect these commitments in the long-term. Addressing entitlement spending is the right thing to do because small changes now can have a bigger impact later. I urge the committee to take a careful look at these specific proposals but also the general issue that the Chairman and others have raised.

As we restrain spending, we are also investing in our Nation's highest priorities, combating terrorism, protecting the homeland, addressing pocketbook issues that affect the standard of living of American families. We have talked about the fact that the budget supports our troops, fighting terrorism abroad. It also invests substantial resources to maintain high levels of military readiness in our DOD base budget and to continue transforming our military to meet the challenges of the new century.

I want to make this point clear, the cost of the war is reflected in the Administration's deficit projections. In fact, again there has been a $165 billion reduction in our deficit the last 2 years, even including substantial war costs.

As noted earlier, the Administration supports greater transparency and accountability in the war costs for Iraq, Afghanistan and the global war on terrorism generally, and this budget does improve the timeliness and specificity of the information provided to you.

With the 2008 budget, we go further than we have in the past. We show full costs of the war through the remainder of the President's term. We provide full costs for 2007 and 2008 for the first time, including account level detail of our request and also justifications.

Specifically, we are requesting additional resources of $99 billion for 2007 for Iraq, Afghanistan, the global war on terror; $145 billion for 2008; and an allowance of 50 billion for anticipated war costs in 2009.

The Administration welcomes more oversight of our war spending and we hope these details we are providing with this budget this week will help you more fully understand our war-related requests.

This is a good faith effort. It is a good faith effort on our part to be as transparent as possible in what we anticipate the needs will be as far out as we can reasonably project.

Mr. Chairman, there is a lot more to talk about in this budget but I will leave it for the dialog with members of this distinguished committee. I will say, in concluding, that the budget before you shows that we can reduce the deficit every year. We can achieve balance by 2012 by keeping the economy strong and imposing sensible and realistic spending restraint. We are committed to working with all members of this committee to ensure that our fiscal house is in order for the time that all of us will be in office, but also for the future.

I am optimistic that we can do it. I think we can do it across party lines, as the American people expect, and as the American people deserve.

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

[The prepared statement of Mr. Portman follows:]

Testimony of OMB Director Robert J. Portman
President's FY 2008 Budget
Committee on the Budget
United States Senate

February 7, 2007

- Chairman Conrad, Ranking Member Gregg, and distinguished members of the Budget Committee, thank you for having me before the Committee today to discuss the President's FY 2008 five-year budget proposal. Building on the reduction in deficits over the last two years of $165 billion, the President's five-year 2008 Budget continues to reduce the deficit every year and balances the budget by 2012.

- We do so while keeping taxes low and meeting our nation's priorities. Although we will have differences on how to achieve balance, our sincere hope is that this budget helps provide the basis for us to work together across party lines to achieve balance in the short term and better position ourselves for the longer term challenges. I believe our plan is realistic: instead of painting a rosy scenario on revenues to get to balance, we take a cautious approach. We have responded to Congressional concerns by showing more war costs, and for the first time we have included these war supplementals as part of the budget in a transparent way. And all of those war costs are included in the calculation of reduced deficits and a balanced budget by 2012.

- We have changed our projections from past years from a freeze or a cut to include a slight increase in non-security discretionary spending throughout the Budget window, consistent with what Congress and the President have actually enacted for the past three years. You will also see that we have eliminated some policies that show budget savings but are unlikely to materialize because of congressional opposition.

- I've had many conversations with Chairman Conrad, Senator Gregg and others on this committee about our biggest fiscal challenge: the unsustainable growth in entitlement programs, such as Medicare, Medicaid and Social Security. I will address this further in a moment, but the progress we are making on getting our fiscal house in order short-term must not distract us from this longer-term challenge. In this Budget, we've proposed sensible reforms, primarily in Medicare, that are less than a one percent reduction in the annual rate of growth, but that represent an important first step in reducing the unsustainable growth in these important programs. I hope we are able to begin addressing these unfunded obligations through the budget process. I also believe Chairman Conrad and Senator Gregg's idea of a bipartisan working group has promise, and I commend them for their personal commitment to addressing the broader entitlement challenges.

- While restraining spending overall, the President's budget also provides new resources for key priorities. It increases funding for our national security to combat terrorism and protect the homeland. It includes new policies to address issues of concern to America's families, including educating our children, access to affordable health care, and reducing energy costs. On the whole, we have attempted to give you a credible and more realistic plan to maximize our chances of working together to achieve balance.

- Over the past two years, we have been able to work together to reduce the deficit by $165 billion for two primary reasons: first, because we have been blessed with a strong economy that has generated record revenues and, second, because we have done a better job of restraining spending, especially keeping non-security spending under inflation for the past three years. It is exactly these elements – a solid economy and reasonable restraint on spending – that can now lead to balance.

[Chart 1: Balancing the Budget Nominal and % of GDP]

- As you can see from this first chart, our budget reduces deficits every year and results in a surplus in 2012. In FY 2007, we project that the deficit will decline to $244 billion – a reduction of $95 billion since our last estimate in July 2006. The deficit in 2008 falls again to $239 billion. As you can see from this chart, this projected FY08 deficit is 1.6 percent as a share of our economy, the key measurement of the deficit because it shows the impact of government borrowing on economic activity. This projected FY 2008 deficit is lower than 18 of the past 25 years, as a percent of our economy. The deficit then continues to decline each year, both in nominal terms and as a percentage of the economy, until we reach a budget surplus of $61 billion in 2012.

- You will recall that three years ago, President Bush established the goal of cutting the federal budget deficit by half in five years from its projected peak in 2004. At the time, many expressed skepticism that this goal could be met, but we achieved this goal last September, three years ahead of schedule. We will now build on that success and work with you to balance the budget within five years.

KEEPING ECONOMY STRONG

Pro-growth policies

[Chart 2: Tax Relief Resulted in Growth in Jobs and Business Investment]

- To keep our economy vibrant, we continue pro-growth policies that have helped fuel our robust economy. The 2008 Budget continues to support growth, innovation, and investment by making permanent the President's tax relief, which would otherwise expire in 2010.

Economy/Jobs

- As you can see from this chart, since the tax relief took full effect in 2003, we have seen strong and steady job growth – with the creation of more than 7.4 million new jobs. We've also seen a dramatic increase in business investment. Productivity is also strong. And paychecks are growing.

Revenue

[Chart 3: Steady Economic Growth Continues]

- After 2003, the economy not only strengthened, but Federal revenues surged – hitting record levels over the past two years. The President's 2008 Budget uses five year economic projections that are in line with forecasts by outside experts. As you can see from this chart, we assume GDP growth will average about 3 percent over the budget window, closely tracking the forecast of the Blue Chip forecasters. This year, our 2.7 percent forecast is now below most outside forecasts and market expectations.

[Chart 4: Receipts Return to Historical Average]

- As you can see from this next chart, with solid economic growth, our total receipts are now at 18.5 percent slightly above the historical average of 18.3 percent – as a share of the economy – and we project receipts remain at or above the historical average for the five-year period.

- We have what I would term a cautious revenue forecast for this Fiscal Year, and going forward. We forecast revenue growth will be 5.5 percent in Fiscal Year 2007 and average 5.4 percent through 2012. This is below the 40-year average of 7.6 percent, and well below the dramatic 11.8 percent and 14.5 percent revenue growth we've seen for the last two years. In fact, it is below the actual first quarter FY 2007 revenue increase of 8.2 percent. As in the past, our revenue projections are produced by the career professionals at the Office of Tax Analysis at the U.S. Treasury. And, as was the case in the past two years, we may well find that our revenue projections are low, and our 2007 deficit projection is high.

- Even with a cautious forecast on revenues, this Budget demonstrates we can achieve balance by 2012 without raising taxes. In addition, we plan to more effectively and efficiently collect the taxes owed through an unprecedented effort to address the tax gap. It approaches the problem in two ways. First, we improve the effectiveness of the IRS' activities with a $410 million package of new initiatives to enhance enforcement and taxpayer service and to improve the IRS' technology. Relying on standard convention, we do not show the additional receipts we expect from this increased compliance activities in our forecast.

Second, we include in the Budget 16 carefully targeted tax law changes that promote compliance while maintaining that important balance between the burden being imposed on taxpayers and our shared interest in collecting taxes owed. These changes are estimated to raise $29 billion over the next ten years.

SENSIBLE AND REALISTIC SPENDING RESTRAINT

- To keep spending under control, our Budget provides realistic spending restraint for the annually appropriated, day-to-day government spending that isn't focused on national security. It strengthens our efforts to better manage taxpayer resources, and it proposes significant budget reforms to eliminate unnecessary and wasteful spending. And as noted earlier, it also takes an important first step in implementing changes needed to address our long-term challenge: the unsustainable growth in entitlement programs.

Domestic Discretionary spending

- As noted, the 2008 Budget proposes to hold the rate of growth for non-security discretionary spending to one percent. We believe that this is both fiscally prudent and realistic. As noted earlier, Congress and the President have done a better job restraining spending in this area over the past few years. In fact, the average growth in this area of non-security spending has been about 1 percent over the past three years, including spending growth in the long term continuing resolution that the House just passed. We believe we can address our nation's top priorities at this level of funding, and our budget does just that.

- Within discretionary spending, the Administration closely examines each program to determine if it is a priority and whether it is effective and producing the intended results. Based on these thorough reviews, the Budget proposes to terminate or reduce 141 discretionary spending programs for a savings of $12.0 billion. These reforms will help us reduce the deficit and channel resources to higher priority and more effective programs. We are able to make these judgments of how to spend taxpayer dollars more wisely, in part, with tools developed through the President's Management Agenda.

Management/ExpectMore.gov

[Chart 5: Expectmore.gov]

- Last year, to ensure greater government accountability, we launched a new website: ExpectMore.gov – which is shown on this next chart. The site includes information for taxpayers on the programs that have been assessed for effectiveness using the Program Assessment Rating Tool, commonly referred to as the PART. With this website, Congress and the public now have an unprecedented view into which programs work, which do not, and what they are doing to improve. It's another way we are providing greater transparency, holding ourselves accountable – and demanding results.

- With the new and improved version of this website launched yesterday, we now have program-level information about the performance of nearly 1,000 Federal programs representing about 96 percent of government and $2.5 trillion of federal spending. I urge Members and staff to check out ExpectMore.gov.

Budget Reforms

- The President's 2008 Budget also outlines a comprehensive series of budget reforms that will improve fiscal restraint, transparency and accountability in Government spending.

- The President has again proposed a legislative line-item veto. I commend Senator Gregg for recently leading a bipartisan effort that resulted in a majority vote to move the legislative line-item through the Senate. The House passed such a bill last year by a 247-172 majority. Both the House and Senate have demonstrated by a majority vote that each chamber supports this legislation. By allowing Congress to take a second look at legislation at the end of the process, we could work together to eliminate unwarranted earmarks and other wasteful and unnecessary spending.

- The Budget also contains the President's key reforms to the earmarking process, which complement the legislative line-item veto.

- The Budget also proposes discretionary spending caps, expanding pay-go so it applies to both discretionary and new mandatory spending.

Entitlements

[Chart 6: Mandatory Spending is Overwhelming the Rest of the Budget]

- Our Budget shows how we can work with you to achieve a balanced budget by 2012, but that accomplishment will be short-lived without addressing our long-term budgetary challenge: the unsustainable growth in Medicare, Medicaid, and Social Security.

- As you can see from this next chart, mandatory spending is overwhelming the rest of the Budget. In the space of four decades, mandatory spending has grown from 26 percent of our budget in 1962 to 53 percent of our budget in 2006.

[Chart 7: Current Trends Are Not Sustainable]

- As the next chart shows, the current trends are not sustainable. Under current law, we estimate that by 2040, spending on these and other important programs, plus interest on the debt attributable to them, would crowd out all other spending—for defense, homeland security, and education.

- It seems to me there is now nearly universal, bipartisan agreement that the unchecked growth of these programs presents real long-term threats to beneficiaries, our federal budget, and the economy. We now face a $32 trillion unfunded obligation in Medicare over the 75 year horizon. Our choices without reform will be massive benefit cuts, enormous deficits and huge tax increases.

- The balanced budget is important, in part, because it better positions our country to address these looming fiscal challenges. But our five-year budget proposal also makes an important <u>down payment</u> toward sensible reform of mandatory spending—reducing spending growth by $96 billion over five years. These reforms are primarily in the Medicare program, but also in Medicaid and other programs. The proposals are similar in character to those this Administration has offered in the past.

[Chart 8: Past Reconciliation Savings]

- To put these reforms in context – as you can see on this next chart – the size of our budget proposal is considerably smaller than the savings in the Balanced Budget Agreement of 1997, the last we worked together on a bipartisan basis to achieve balance.

- Although an important first step, the savings in this proposal would only reduce the unsustainable annual growth rates of mandatory spending by less than one percent. Specifically, over 10 years the annual rate of growth in Medicare would be reduced from 7.4 % to 6.7%. However, while these proposals deliver relatively small savings in the short-term, the effects that build over time are substantial. The changes we have proposed to Medicare would reduce the unfunded obligation of the program by 25 percent or $8 trillion over the next 75 years.

- Frankly, under our policies, we can achieve a balanced budget within the five-year window without any of these mandatory savings, but we would only be digging a deeper hole by ignoring it for another year. Balance is not coming at the expense of our nation's commitment to seniors and low-income Americans – quite the opposite. We must begin the reform of these programs now in order to protect those commitments. Addressing entitlement spending is the right thing to do because small changes now have a big impact later. I urge you to take a careful look at these sensible reforms.

INVESTING IN CRITICAL PRIORITIES

- As we restrain spending, we're also investing in our nation's highest priorities: combating terrorism, protecting the homeland and addressing pocketbook issues that affect the standard of living for American families.

Global War on Terror

- The 2008 Budget supports our troops fighting terrorism abroad, strengthens our military for the future, supports our efforts on the diplomatic front, and protects our homeland from attack. It invests substantial resources to maintain high levels of military readiness and to continue the transformation of our military to meet the new threats of the 21st Century.
- I want to make this next point very clearly because I find it is often misunderstood. The cost of the war is reflected in the Administration's deficit projections. In fact, there has been a $165 billion reduction in our deficit over the past two years even with substantial war costs.
- As noted earlier, the Administration supports greater transparency and accountability, and this budget improves the timeliness and specificity of the information provided to you and the American public about the cost of the war.
- With the 2008 Budget, the Administration goes further than we have in the past – we show the full costs of the war through the rest of the President's term. We are providing our request for the full costs of the war in both FY2007 and 2008 – and for the first time including account level detail and justifications. Specifically, we are requesting additional resources of $99 billion for FY 2007 to support Iraq, Afghanistan, and the Global War on Terror, $145 billion for FY 2008, and an allowance of $50 billion for anticipated war costs in FY 2009. The Administration welcomes oversight of its war spending, and we hope these details will help you more fully understand our war-related requests.

- This is our good faith effort to be as transparent as possible in what we anticipate the needs will be as far out as we can reasonably project.

Education, Health Care, and Energy

- The President's Budget addresses three key issues that are on the minds of many American families: the quality and cost of their children's education, access to affordable health care, and our Nation's dependence on foreign sources of energy from unstable parts of the world.

- Regarding our schools, No Child Left Behind (NCLB) is already working to achieve the goal of all students performing at or above grade level in reading and math by 2014. It has raised student achievement for millions of children in schools nationwide. The 2008 Budget directs more funding to high schools to better prepare our students for college or the workplace, and offers new school choice options so children in low-performing schools have a chance to attend a school where they can learn and succeed. To help low-income families afford college, the 2008 Budget substantially increases Pell Grant maximum awards.

- The 2008 Budget also improves Americans' access to affordable health care through a number of proposals. It proposes a significant change in the tax treatment of health care to expand coverage and bring greater fairness to the system. With more transparency and competition, it will also slow the growth of health care costs, all of which will reduce the number of uninsured Americans.

- The Budget includes a number of proposals to increase our energy security while improving our environment. As noted in his State of the Union speech, the President is proposing to increase the current standards for the use of alternative fuels and for fuel economy in order to cut our domestic gasoline consumption by 20 percent over the next ten years, thereby reducing projected air pollution and $CO2$ emissions.

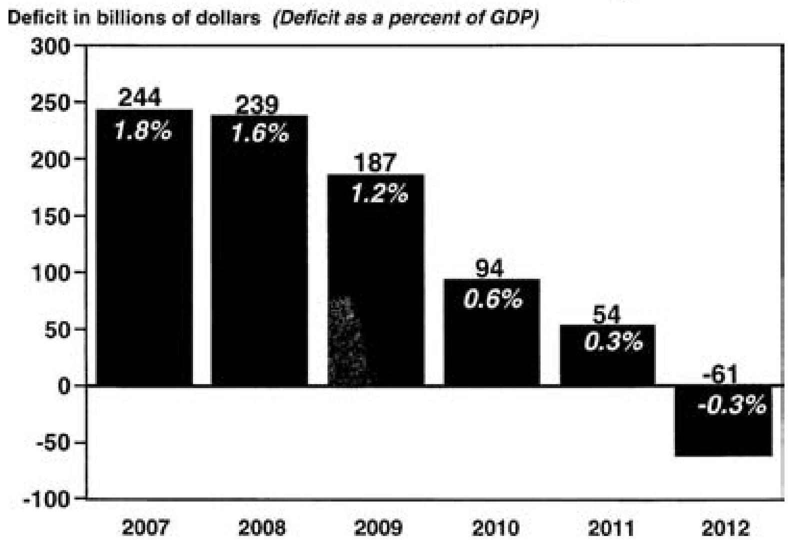
- The Budget also continues the Advanced Energy Initiative to make alternative sources of fuel and electrical energy –like cellulosic, hydrogen, solar, nuclear and clean coal – more cost-competitive.

Conclusion

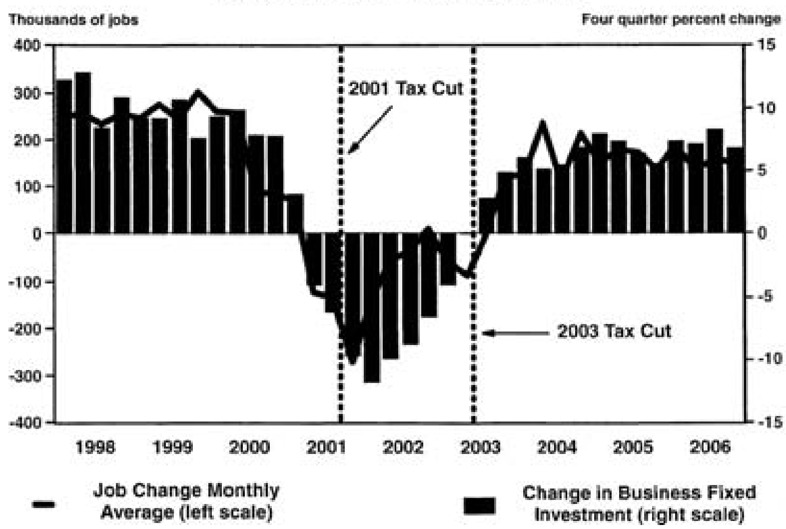
- Mr. Chairman, the Budget before you shows that we can reduce the deficit every year and achieve balance in 2012 by keeping the economy strong and imposing sensible and realistic spending restraint. We are committed to working with all members of the committee to ensure that our fiscal house is in order for the time all of us will be in office – but also for the future. I am optimistic we can do it — across party lines — as the American people expect and deserve.

- Mr. Chairman, thank you for the time, and I look forward to your questions.

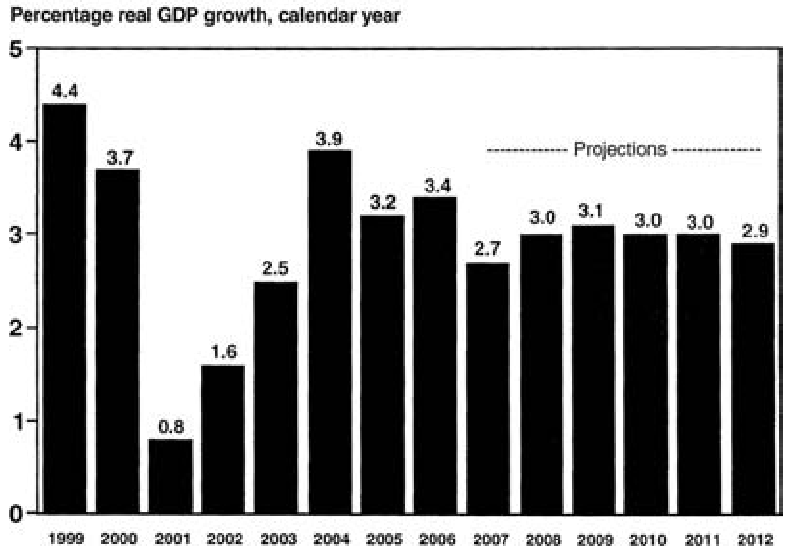
Balancing the Budget



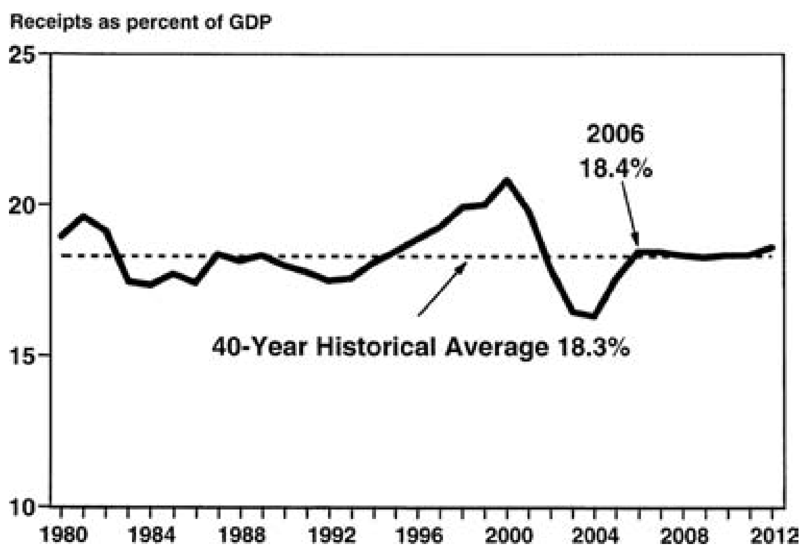
Tax Relief Resulted in Growth in Jobs and Business Investment



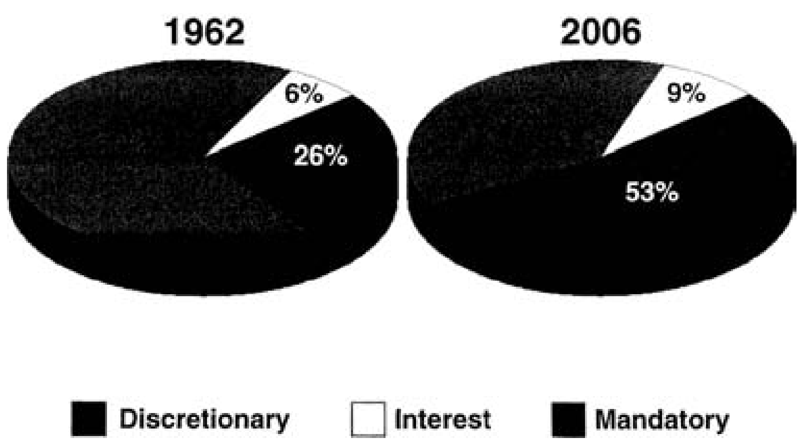
Steady Economic Growth Continues

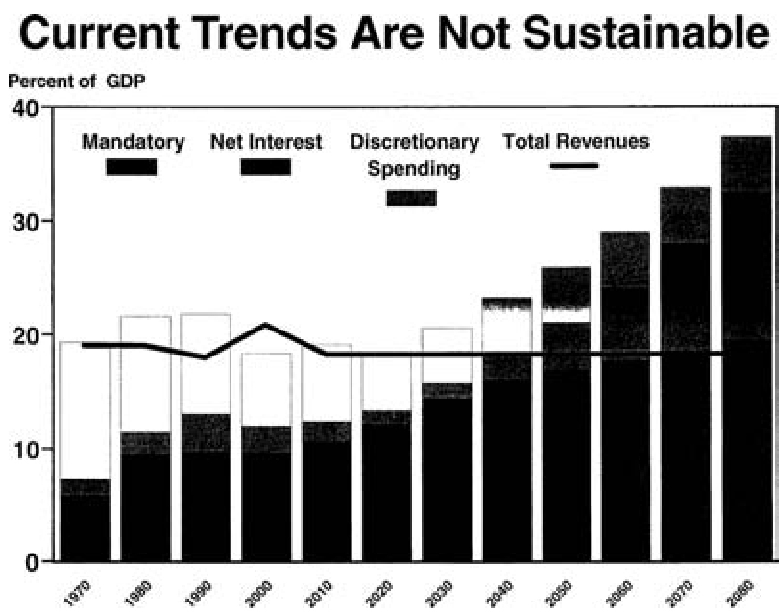


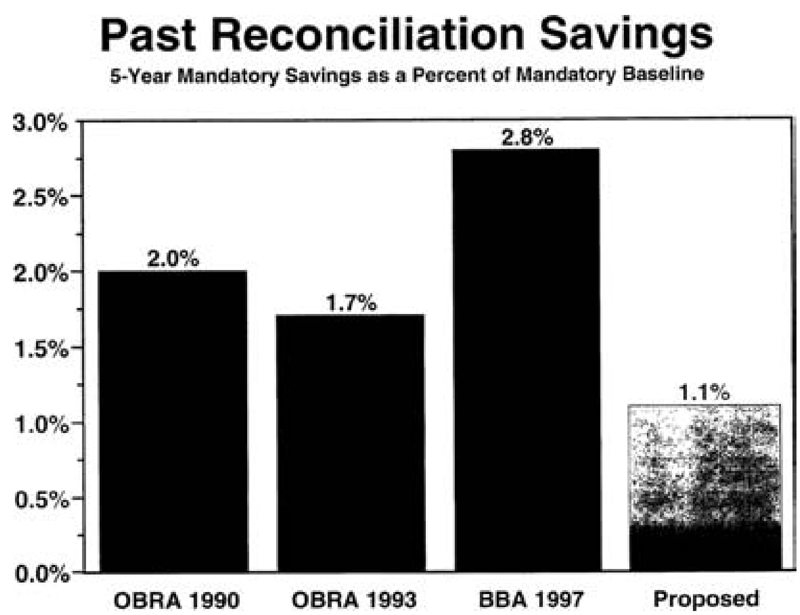
Receipts Return to Historical Average



Mandatory Spending is Overwhelming the Rest of the Budget







Chairman CONRAD. Thank you, Director Portman.

Let me address a couple of the things that you have talked about. You talked about the deficit as being in comparison to previous deficits.

The problem, of course, it is very difficult to compare now because we have such large temporary surpluses, especially in Social Security, that are not counted in your deficit calculation but that are added to the debt.

For last year, the reported deficit was $248 billion. But the gross debt of the country increased by $546 billion. So when the assertions are made that the deficit was less than 2 percent of GDP, the fact is the debt of the country increased by more than 4 percent of GDP. And the biggest difference is the Social Security funds that are in temporary surpluses that are being used to pay the operating costs of the Federal Government.

In the private sector, if anybody tried to do this, if anybody tried to take the retirement funds of their employees and pay operating expenses, they would be headed for a Federal institution. But it would not be the Congress of the United States and it would not be the White House. They would be headed to the big house, because that is a violation of Federal law.

So I hear this over and over, that our deficit as a share of GDP is manageable. Nobody is talking about the debt. This debt is being run up at the worst possible time, before the baby boomers retire.

The second point that you made that I want to respond to is the correlation you have made between the tax cuts and the economic recovery. I would point out that if you compared it to the Clinton years, you would see a similar pattern, actually an even better pattern of both job creation and economic growth. And that was after a tax increase.

So I do not know if you would now say well, it was the tax increase that drove those remarkable economic results of the Clinton years, that showed the strongest economic growth in the Nation's history, showed the strongest business expansion in the Nation's history, the lowest unemployment in 30 years, the lowest inflation in 30 years, after a tax increase.

It reminds me very much of the story of the elderly woman who was on her porch and it was a very hot day, the pavement was melting. And she fainted. And her nephew concluded that it must be the melting pavement that had caused her to faint.

I think you are attributing the economic growth to the wrong cause. I think it is the recovery. And we see, in every recovery revenue growth, jobs expand. And we have seen it, we saw in the Clinton years after a tax increase.

Let me just say, this recovery is running on revenue. We went back and looked at all of the recoveries since World War II. This is by far the weakest. This recovery on revenue is running $127 billion behind the average of the nine major recoveries since World War II.

On job creation, let us go to that next slide. On job creation, this recovery is running 6.5 million private sector jobs behind the typical recovery since World War II.

So I think the analysis here of what is causing what is just misplaced.

And the longer-term implication of the President's plan is to dig the whole much deeper. The President's plan, that says we are going to extend all of the tax cuts at a cost of $2 trillion over 10 years, dwarfs the savings that the President has called for on the mandatory side.

I indicated your savings on the mandatory side, $280 billion over 10 years, is absolutely dwarfed by the tax cuts. So you wind up in a worse position.

Let's go to where we might agree, because there are places that you and I agree. The place we agree is our long-term prognosis on the need to face up to the fiscal imbalances. We have tried, Senator Gregg and I, to bring both sides to the table to devise a solution. To me, the only way that happens is if both sides are prepared to compromise.

You have said everything is on the table. What do you mean by that?

Mr. PORTMAN. Thank you, Mr. Chairman, and welcome to Senator Gregg. I talked about you and Chairman Conrad talked about you, so it is good you are here to defend yourself.

First of all, I agree with you. I think it is incredibly important that we, as public officials on both sides of Pennsylvania Avenue, and both sides of the aisle, acknowledged the problem. I commended you for that in my testimony and you and I have talked about that a number of times. Because the long-term unobligated—the long-term liabilities and obligations that are currently unfunded is really the fiscal challenge we face.

We are doing a much better job in getting our fiscal house in order short-term. And what the President has said recently is not only a specific proposal for a bipartisan commission to deal with the entitlement challenge, but he has said that there should be no preconditions, meaning that, in fact, everything should be on the table.

He has also, as you know, shown some political courage in taking on some of these specific issues. We do it again in this budget. I have laid out for you what we think are sensible and reasonable changes in some of the programs that create the biggest challenge longer term.

We talked about the $32 trillion unfunded obligation in Medicare. The President has also been way out front on the issue of Social Security and, as you know, we were not successful in getting Congress to take up those reforms. But he continues to believe that this is the biggest fiscal challenge that we face and we should address it and we should do so in a bipartisan way.

Chairman CONRAD. Let me just followup and ask you, if I can, this question: when you say no preconditions, does that mean that you can foresee a resolution that includes both additional revenue as well as reduction in expenses for the long-term entitlements?

Mr. PORTMAN. I think it is critical we not pre-judge at this point where we are going to end up in the long-term, because in that case—

Chairman CONRAD. I am not asking for a conclusion. I am asking though, when your side says there is no preconditions—because you say this, Secretary Paulson says it. But then I see the President and the Vice President, when they are interview publicly, slam the door in terms of revenue.

So we need to know, if there is really going to be a serious discussion, it cannot be a circumstance in which one side, clearly

Democrats are the preeminent defenders of Medicare and Social Security. Republicans are the preeminent defenders of tax cuts. That is the reality.

So the question is are both sides to compromise? Are both sides to give ground here? Or is only one side to give ground?

Mr. PORTMAN. I would take issue with your premise that Republicans who are trying to be sure these programs are around for future beneficiaries are not defenders of Medicare and Medicaid and Social Security. It is precisely because we think these programs are so important that we are willing to take what are politically difficult steps to try to ensure the commitment is there for future generations.

I think that is the responsible thing to do.

Chairman CONRAD. I would just say the problem is you are cooking a fiscal stew that is going to guarantee that there have to be more draconian cuts because you are using Social Security—we can get into that debate. I had hoped to try to reach conclusion on is there a serious chance for a discussion on the longer-term.

But look—

Mr. PORTMAN. There is absolutely, absolutely a serious change. But I would not—

Chairman CONRAD. The fiscal reality is the President has run up the debt $3 trillion. That threatens Social Security and Medicare. It threatens Social Security to take $180 or $190 billion of Social Security money and use it, instead of paying down debt or prepaying the liability, to use it to pay the operating expenses of the Government. But that is the President's fiscal plan every year for the next 10 years.

That makes the long-term solvency of Social Security more difficult.

Mr. PORTMAN. The issue on Social Security is that we need to reform the program so that it is able to sustain itself over time. I totally agree with you on the way you were calculating various approaches to looking at the deficit or even the long-term debt. We should have all that information. All of that is provided, by the way, in this financial report of the United States that I sent to you all personally. It is up on our website. I encourage every American to look at it. You can look at the debt and the deficit in a number of different ways.

Chairman CONRAD. So is revenue on the table? If there is a discussion, if we come together for a negotiation, is revenue on the table as far as the Administration is concerned?

Mr. PORTMAN. Again, I do not know how I can be more clear, but what the President has said recently—and this is not, again, something that was being said a year ago or even 6 months ago. And I think we should note that we have a long-standing view, and I have laid it out in our budget very clearly why we believe that we do not need additional revenues to get to a balance in 2012. I have shown you what the percent of the revenue is as to the economy, which is the burden on the economy, how it grows and does not go down—

Chairman CONRAD. But I am talking Beyond—as you know, I am talking beyond 2012.

Mr. PORTMAN. Our long-term figures show the same thing, which is we do not fall below that historic average. The question is what should the burden be on this economy? Do we want to risk the 7.4 million new jobs we have created since 2003, the economic recovery that has enabled us to generate those revenues.

Chairman CONRAD. Director Portman, you are doing exactly what I feared—

Mr. PORTMAN. No, no, but this is nothing new.

Chairman CONRAD [continuing]. Which is that this is all going to be done—

Mr. PORTMAN. This is our policy view.

Chairman CONRAD. What I am hearing from you is exactly what I hear publicly from the President and the Vice President, that this is only going to be done on the cost-cutting side, which clearly has to be done, but nothing on the revenue side. If that is what you postulate, then there will not be a conclusion because then you are only asking one side fundamentally to compromise. If both sides are not prepared to compromise, there will not be a resolution during this administration. And that would be a tragedy.

Mr. PORTMAN. What I am saying is we should have the discussion with no preconditions on either side.

Chairman CONRAD. Senator Gregg.

Senator GREGG. This is the gravamen, to use a legal term, of the fiscal year issue of this Nation, which is how we handle the long-term entitlement costs and the fact that those costs exceed significantly revenues, and the fact that you cannot tax your way out of this problem because the burden of these costs is accelerating at a point that they could easily absorb not only the entire Federal budget but well beyond the Federal budget, maybe as much as 30 percent of gross national product. Today, of course, the Federal Government only—that is three programs, 30 percent of gross national product.

I want to congratulate you, though, for—I had hoped we would reach a resolution that would allow us to sit down and set up a process which would lead to a policy which would take a global response and would address the entitlements, the major entitlements, primarily the health care entitlements and Social Security, and would also have to address revenue side. We are not going to get there without looking at both pictures, but the majority of the effort has to be on the benefit side.

But it does not appear that the climate is going to allow that for a variety of reasons. I do not think the blame lies at the White House entirely, although some comments were not constructive. I think there is also a problem with some skittishness on the other side of the aisle, relative to making what would be a very courageous act of actually addressing the benefit structure of these programs.

But I do want to congratulate you folks for putting forward a major step in the area independent of a global settlement with your proposal on Medicare which, as we know, Medicare has approximately a $35 to $40 trillion—that is with a T—unfunded liability over its actuarial life, the actuarial life being essentially the retirement of the baby boom generation.

That liability is so huge that it will essentially bankrupt our children's capacity to have a decent lifestyle. Our children will not be able to afford that system. And they well be left with a lifestyle much less of quality than what our generation has had, and our generation will have done an incredible unfairness to our children by leaving them with this debt and putting this debt on them.

We have to address that. Now I would hope for a global settlement but we are not going to get there, it appears, because the parties are backing away.

But least you have come forward with a proposal which reduces significantly that number. As I understand your proposal, which represents about $90 billion over 5 years, translates into about $8 trillion over the actuarial life, which is about 25 percent of the problem. That is a huge step.

As I also understand your proposal, it does not address—it does not reduce benefits to beneficiaries. It calculates more accurately the reimbursement inflation rate for hospitals and for provider groups, which should be gone. And it also says that Bill Gates's father and other people who are fairly wealthy, very wealthy, should not be subsidized by working Americans who are working at restaurants and gas stations across this country, and their doctors' cost and their drug costs. And those two items primarily are the drivers of this very dramatic reduction in the out-year liability.

I guess I have two questions for you. First, is that an accurate description of what you are doing? I am sorry that I was not earlier, maybe you have already gone through this. There was some issue on the floor that has drawn me away on occasion.

And second, I would hope that if that is true, that at least our colleagues on the other side the aisle, when they draw up their budget, would at least take this element of the major reform effort, which is a significant element, and run with that one.

Mr. PORTMAN. I appreciate the fact that you have described it well, and better than I did in my testimony, because you have talked about what the impact is on beneficiaries. You are right, for the vast majority of Medicare beneficiaries there is not only no impact, it is a positive impact in the sense that their premiums will go down. Because as you know, in Part B they pay 25 percent of the premium.

Senator GREGG. And the system will be made more solvent.

Mr. PORTMAN. And the system is made more solvent, which is the ultimate benefit to all of us, to be able to protect these programs over time. For higher income seniors there is more means testing. I am told I should use the word income relating. But what it means is—

Senator GREGG. No, we are just going to make high-income seniors pay the fair cost of what we are giving them. That is reasonable.

Mr. PORTMAN. It is 5.6 percent of seniors. Again, every other beneficiary will see a reduction in their premiums, not an increase, a reduction. But for 5.6 percent of seniors there will be less of a Federal subsidy under Part B and under Part D for the premiums. But it is 5.6 percent of seniors. It is actually 2.7 percent of seniors in Part D.

Senator GREGG. What percent of that $8 trillion is tied to the adjustment of premiums for high-income seniors?

Mr. PORTMAN. About half, over time.

Senator GREGG. And the other half is to get the COLA right for reimbursement; is that correct?

Mr. PORTMAN. That is correct, what we believe is an appropriate reimbursement for the providers, clinics, labs, hospitals.

Senator GREGG. I do not think either of those should be controversial. I mean, obviously the provider groups are going to go crazy. But a fair reimbursement rate is a fair reimbursement rate, and having high-income seniors pay a much higher percentage of the cost of their premium is a reasonable thing.

I would hope that as our Democratic colleagues develop their budget, they would consider putting that in there, too, so we would have it in both budgets and there would be consensus.

Thank you.

Mr. PORTMAN. Thank you, Senator.

Chairman CONRAD. I would just say for me, I voted to do that. One night in the Finance Committee a number of years ago, a group of us just got so tired of this stale debate that we did a whole series of things. And it actually passed the Finance Committee overwhelmingly on a bipartisan vote. And when we told our other colleagues about it, they retreated. But we were prepared—

Senator GREGG. I think we should give the Finance Committee another opportunity to do that.

Chairman CONRAD. That may be a very positive idea.

Senator SANDERS.

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

Rob, how are you?

I look at the world a little bit differently than you do and a little bit differently than some of my colleagues. Let me tell you the world that I look at.

Since the Bush Administration has been in office, and I did not hear you mention this word once, poverty has increased by 5 million Americans. Is that an issue that maybe we might want to be talking about?

Not only does the United States have the highest rate of poverty of any major country in the industrialized world, but I think more outrageously we have by far the highest rate of childhood poverty, way above what Europe and Scandinavia does. I do not hear one word coming out of the Administration on that issue, 37 million Americans living in poverty today.

Median income for working-age families has declined for 5 years in a row while the price of health care, housing, energy and college tuition has skyrocketed.

Meanwhile, and this is an issue that we have to place on the table as well, while poverty is increasing and while millions of Americans are working longer hours for lower wages, the people on top have never had it so good. You cannot just look at an economy and say everything is going well. Well, it is not. Poverty is increasing, middle class is shrinking, people on top have never had it so good, not since the 1920's.

According to Forbes Magazine, the collective net worth of the wealthiest 400 Americans increased by $120 billion last year, to

$1.25 trillion. The 400 wealthiest Americans are worth $1.25 trillion. At the same time, 37 million Americans are mired in poverty and 47 million Americans have no health insurance.

That is the reality that I see, and maybe that is the reality every now and then this committee might want to talk about, just occasionally.

Now a budget is a reflection our values. It tells us what we believe and where we want to go. The way I see the budget being presented is at a time when the wealthiest people have never had it so good, what you do is suggest that we maintain huge tax breaks for millionaires and billionaires. It does not seem fair to me. It does not seem right to me.

Meanwhile, while poverty is increasing and millions of Americans are really struggling just to keep their heads above water, what I see, as the chairman indicated, Vermont may not be as cold as North Dakota, it gets pretty cold in Vermont, it gets pretty cold in New Hampshire. LIHEAP, 40 percent of whose participants are seniors, will be cut. The Commodity Supplemental Food Program, which provides a package of groceries to low income seniors once a month, is cut. Community Service Block Grants, which provide the infrastructure for the delivery of services to low-income people, is cut.

Now we talk about a war budget and the war in Iraq, and yet in my State, and almost all over this country, veterans today are on waiting lists. And what you propose in your budget is to raise fees on veterans for their health care by $355 million in 2008, the result of which will be driving, which is the purpose, hundreds of thousands of veterans off of VA health care.

Now maybe some people think that is a way to say thank you to the people who have put their lives on the line defending our country. I personally do not.

When we have the highest rate of childhood poverty, you are proposing cutting back on Head Start and child care.

Now Rob, I do not know what goes on other parts of the country, but I will tell you that in Vermont, child care is a disaster. It is very hard for families to find affordable quality child care. And you are cutting back on that.

Question: at a time when we are seeing an escalation of millionaires and billionaires at the same time as we are seeing a huge increase in poverty and a decline in the standard of living of millions of American workers, do you really think it is appropriate to cut back on programs for low-income people and maintain tax breaks for millionaires?

A pretty simple.

Mr. PORTMAN. Senator Sanders, I thank you for your question and I know we are going to have differences in our views or approaches. But just, if I could, tell you a little bit about what we are looking at now in terms of the economy, where it is relative to where it was maybe a few years ago in terms of what you were talking about, working families and their paychecks.

Senator Conrad talked about the fact that recoveries typically involve not just an increase in revenues, but they also involve, I will say, an increase in wages. If you look at what is happening today and in the last year in particular, we have seen real wages going up. We did not see that early in the recovery. By the way, we DID not see that in the recovery in the 1990's either. In fact, we are ahead of the 1990's recovery in terms of from the recession until now how much wages have gone up. Talking about real wages, after inflation. And we are able to show that now. And thank goodness, and it is a great thing for working families.

So over the last 12 months, we have seen a change in that, partly frankly because energy prices have gone down some. But mostly it is because, as with the recoveries over the last four decades, wage growth tends to follow the productivity growth, the GDP growth, and it is now happening and it is kicking in. And working families and people who punch a time clock around this country every day are now seeing the benefits of the better economy. That is a good thing. And that is affecting some of the income inequality issues that you raise.

I can give you all of the data on that that we have now got from Treasury and from the Labor Department and so on, but that is good news. And it was not true a year ago.

Senator SANDERS. If I could, my time is limited and I do not mean to be rude.

Child care, a horrendous situation, I think, all over this country. I do not know if you acknowledge that or not, affordable child care hard to come by almost any place. And yet you guys are cutting back on child care, you are cutting back on Head Start.

Explain to me why you think that is a right thing to do within the context of our country, having the highest rate of childhood poverty?

Mr. PORTMAN. Let me get the Head Start numbers.

I have a little bit of a challenge here because, as you know, Congress is about to pass a new Head Start provision, or the Senate I think is poised to pass something. The House has passed in the last week, new numbers.

Our number is based on the expected changes. The 2007 request would have been a slight increase. The number I have now in front of me on, at least what the House passed and what I assume you all will pass, is our request is actually an increase of 1.45 percent.

Senator SANDERS. We see it as a reduction from the continuing resolution. That is the numbers that I have.

Mr. PORTMAN. I have all of the numbers. We can share these with you. But it takes me a minute because this H.J. Res., which is the new long-term CR, changes the numbers somewhat. You are providing—

Senator SANDERS. Tell me about the—

Mr. PORTMAN. Can I talk about the fees just for a second, because it is a very important issue.

Chairman CONRAD. We need to close this out because the Senator's time has expired.

Mr. PORTMAN. I am happy to get with you afterwards, but we think we have a good policy here, a big increase again, 7.6 percent in the veterans budget, 7.4 percent increase in medical care for our veterans this year, building on the increases we have had of 64 percent since 2001.

Chairman CONRAD. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

We had some discussion about the debt, as opposed to the deficit, and how Social Security plays into that. Is there some way that we can change our debt problem without changing the law pertaining to Social Security and the transfers of dollars from Social Security to the general fund? I do not see how that happens.

Mr. PORTMAN. No, it would require legislation.

The point I was making earlier was that I agree the Chairman in the sense that we ought to look at our deficit and our debt in various ways. One is the unified budget. That is how we have done it since 1967. That is how this committee will, I assume, propose your own budget. It will not include the surpluses in Social Security.

That is how the CBO does it, the non-partisan Congressional Budget Office. That is how the Clinton Administration did it. That is how we do it.

My point was I think it is helpful, frankly, to look at it another way, which is to look at not just our net operating costs, which would include our real liabilities like veterans or military retirees or Government retirees—which by the way, again, is here. You can look at the net operating cost of the Government as well as our unified budget.

Also, I think it is helpful to look at it in terms of what are our unfunded obligations, which would include Social Security and Medicare?

But the point, Senator Allard, that you made and that I am trying to make, is at a minimum we should agree to get to balance on a unified basis. The unified budget that we all have been using since 1967 is all money in and all money out. So all fees, all payroll taxes, all income taxes into the Government, and then all the money we pay out. At a minimum, let's get to balance on that basis. And that will require some spending restraint.

On the other hand, if you look at what Congress has done the last couple of years, we are on track to be able to achieve that, as long as the economy continues to grow. That is why keeping the tax relief in place is so important.

The one thing I did not get a chance to do, in responding to Senator Sanders' comments, is to say that one reason we feel so strongly about the tax relief staying in place is because of this correlation we see between its implementation in 2003 and the growth in jobs and productivity and investment. But also because if you reduce the existing tax relief that is in place, it will be a tax increase on America's families.

Or if you are focused more on the economic impact overall, you have to acknowledge that it is a big increases in taxes on America's small businesses, which are creating so much of the economic activity and new job growth. More than half of the new jobs are being created by small businesses, 90 percent of whom filed their taxes through the individual tax system.

So if you raise people's taxes, Mr. Sanders talked about going after the wealthy individuals. Well, you are also going after America's businesses. In fact, it is the more profitable small businesses that, of course, are generating more jobs, expanding their plant and equipment and people. And 75 percent of those small businesses have income in these top two brackets that we are talking about.

So this is a very important part of the President's tax relief, as well.

Of course, on the capital gains side, on the dividend relief side that you supported so strongly, Mr. Allard, very important to encourage investment to keep that moving forward.

Chairman Conrad talked about the difference between this recovery and the last recovery. He noted that there were tax increases in the early 1990's. That is true. But when the economy really took off in the late 1990's, including 1997 when we came together as Republicans and Democrats, we actually cut taxes.

Senator Bunning was on the Ways and Means Committee there at that time and he helped do that. It was on capital gains. And it resulted in new revenues in capital gains that were beyond anybody's expectations. It helped us, as you know, get to balance in the late 1990's sooner than anybody thought we could.

We had a 5-year balanced budget then, as we are proposing now. We actually got there a couple of years early, partly because of those capital gains receipts that came in because of a tax cut in 1997.

Senator ALLARD. I want to make an additional point here, my time is running out here. I just put a chart up on the screen there to the right which shows high income taxpayers bear a greater burden under Bush. If you compare the Clinton Administration, it is 81.2 percent. If you compare the Bush Administration, who brought in tax cuts, we see it goes up to 84.9 percent.

So in real figures what is happening in revenues coming into the Federal Government, we see a greater proportion of that coming from the high income taxpayer.

Mr. PORTMAN. That is a fair point and it is accurate. After all the Bush tax cuts are implemented, the top 10 percent pays about 66 percent of the burden rather than 64 percent of the burden, and that would be consistent with your chart.

That is because of the refundable nature of the child tax credit, as you know, the expansion of the 10 percent bracket. Also the way the marriage penalty works. As you know, 4 to 5 million taxpayers do not pay any Federal income tax now who did previously, who are lower income Americans who benefit from the tax relief.

So you are right to point that out. The point I was making is another aspect of it, which is among those higher income taxpayers a lot of them are small businesses. Because of the way our tax system works small businesses, for the most part, are in the individual tax system, not in the corporate tax system.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Allard.

Senator MENENDEZ.

Senator MENENDEZ. Thank you, Mr. Chairman.

Director, it is good to see you. I enjoyed my time in service in the House with you.

Let me start off by saying that in 2003 a different White House Budget Director told the Congress that the war in Iraq would maybe hit $50 or $60 billion at most. We have spent seven times that much. So I want to look at the present request by the Administration in this budget on Iraq.

As I understand it, the President is asking for about $179 billion for Iraq in 2007 and 2008; is that correct?

Mr. PORTMAN. That is correct, Senator. It is $170 billion roughly total, a little less than that, but about $170 billion for 2007 when you add the bridge that you all passed back in October. And then it is, for 2008, another roughly $145 billion, about $141 billion on the DOD side, and $145 billion total for Iraq, Afghanistan, global war on terror for 2008.

Senator MENENDEZ. One of the things I would hope that you would make more clear in the future, you have to be a CPA/rocket scientist to go through the way—instead of very clearly saying here is how much we want for the war in Iraq, here is how much we want for Afghanistan, the Administration mixes it in such a way. It should not have to take a rocket scientist to figure it out.

But having figured it out, isn't it a fact that these numbers, CBO has told the Congress that they see the escalation of the war costing much more than that. And it is either oversight or deceit by the Administration not to have an extrapolation of the facts that there is going to be a lot of support personnel in addition to the actual troop deployment that is necessary. And that does not seem to be factored in in this budget.

Mr. PORTMAN. I am glad you asked that question. It is neither oversight or deceit. It is a different plan. I spoke to the director CBO, for whom I have a lot of respect, I know you know him well, Peter Orszag, about this. I just wish they had called us because they assume that this goes into 2008. First, we do not. It is a different policy. You can hold us accountable for our policy, but our policy is this is a fiscal 2007, not a fiscal 2008/fiscal 2009 exercise.

Senator MENENDEZ. So the Administration is going to deviate totally away from the military standard operating procedure for the purposes of support personnel? It is going to move totally away—

Mr. PORTMAN. That is another issue.

Senator MENENDEZ [continuing]. From its historical realities. And you are not going to come back to us for a supplemental this year; right?

Mr. PORTMAN. That is another issue and I should have addressed that earlier. On the plan that the President has laid out for increased brigades he is assuming, and this is our plan, that we will extend the deployment of many troops who are in Iraq now. The CBO assumed that we would be sending reinforcements in that were brigades from the United States or other bases. So it is just a different plan.

The support troops that you are talking would also, under our plan, many of whom would be in Iraq now or in the theater, they would be extended, as well.

Senator MENENDEZ. So you are going to send 22,000 troops more and not send virtually any more support troops for those 22,000?

Mr. PORTMAN. No, we have built into our estimate, which is $5.6 billion, the support troops necessary to support the additional brigades.

Senator MENENDEZ. So you are not going to come back to us for a supplemental?

Mr. PORTMAN. Well, we will see what happens on the ground. With regard to the particular issue of what we are doing on the additional brigades, the reinforcements in this new plan, we have our full costs in the fiscal year 2007 supplemental.

Senator MENENDEZ. How do you go in 2009 to $50 billion? How do you go from $170 billion, especially with the President's escalation of the war, and then tell the Congress that in 2009 you are going to have $50 billion?

Mr. PORTMAN. It is not an estimate of full war costs in 2009. You are correct.

Senator MENENDEZ. So it is going to be a lot more than that.

Mr. PORTMAN. I do not know. Nor does anybody on this committee.

Senator MENENDEZ. How can you talk about a balanced budget when you are throwing out a figure that is clearly underfunded from its present reality?

Mr. PORTMAN. If the President's plan works as we believe it will, and as I know Americans hope it will, which is that it will result in less of a commitment by our country to Iraq because we will be able to quell some of the sectarian violence that has flared—

Senator MENENDEZ. Two-thirds less? Two-thirds less in 1 year?

Mr. PORTMAN. No, I am talking about 2007 now. We are in 2007 now and that is the funding that provides for the increased reinforcements in 2007.

In 2008, we actually provide, and this may make you feel better about things, a straight line. In other words, in 2008, we do not assume, for purposes of our budget, that there will be a decrease in our activity. We hope and expect there will be, but to be prudent in 2008 it is just a straight line.

Senator MENENDEZ. What will have you come back here for a supplemental? What facts will change on the ground that will have you come back here for a supplemental?

We had testimony here by a panel of experts that say they believe that notwithstanding what you have put in the budget, you are going to be coming back for a supplemental. What would be the factors that you might have that you will have to come for a supplemental?

Mr. PORTMAN. Changed circumstances on the ground, and it can go either way, honestly. What we have provided is, I think, a prudent 2007 and 2008 estimate. And 2007–2008, by the way, are being provided to you for the first time at the account level, breaking out Afghanistan. I agree with you that in the past we have not provided the kind of transparency that is most helpful to Congress for oversight.

These two boxes, that I will not make somebody put on the table, include the justifications. So it is not just the account level, which we have not provided previously with the budget, but it is all the justifications now, not justifications to come later.

It will not take a rocket scientist to look through it. It will take some time because there is a lot of detail there. And we are saying for 2007, we believe this to be our full cost. You can look at our assumptions. You can look at our request for 2008, which is something that is difficult for military planners to do because much of this money will not be spent for 18 months or 2 years or more. We are basically giving you a straight line from 2007 in terms of military operations.

Now again, we believe that we will be able to see some success with the reinforcements that will not make that necessary. But out of prudence, we are providing that.

I just want you to be aware of that. There is no opportunity for members of this committee or for war planners at the Pentagon to have a window into exactly what is going to happen. Nobody has a crystal ball. So that is why I cannot answer your question as to whether there might be another supplemental request sometime in the future. I just do not know.

But I do think that by providing more information to you and giving it to you in a more transparent way with all of the justifications and account level detail, we are being more responsive to the concerns that have been raised.

Senator MENENDEZ. Mr. Chairman, I just want to close by saying that I am concerned that we do not have the full figures here, that we will end up with a supplemental. And supplemental is deficit funding at the end of the day. That is how the Administration has largely funded this war.

Thank you.

Chairman CONRAD. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Director Portman, I am concerned about the rate of growth of our entitlement programs. You are also, particularly Medicare and Medicaid.

The President's budget takes steps to slow the rate of growth in these programs. In other words, we are not cutting but the growth rate is slowed. For example, in Medicare the President has proposed reducing the growth rate in the program from 6.5 to 5.6 over 5 years. In Medicaid the rate of growth is reduced from 7.3 to 7.1.

And I looked at it over a period of 75 years. Out-years are particularly a concern to my 35 grandkids and my four great-grandkids. If we do what is proposed to be done, the Medicare unfunded 75-year unfunded liability is reduced by 25 percent or $8 trillion. I think that is very important.

Is that the reason that we are biting the apple now, not reducing any benefits, but if we do not take that reduction in increase now that the out-years just get worse and worse as we go down the pike?

Mr. PORTMAN. Yes, you are absolutely right. We talked about this a little bit earlier, but by making relatively small changes now that are sensible policy changes, we can have a significant impact in the out-years.

I will also tell you this is not enough to address the problems that Senator Gregg and Chairman Conrad discussed earlier. In other words, we will need, as a Congress and as an administration, to sit down and work out even further sensible reforms to not just Medicare but also Medicaid and Social Security.

On your numbers, you are absolutely right. Over the 10-year period, by the way, the Medicare growth is 7.4 percent under current projections. The implementation of all of these proposals we have on Medicare takes it to 6.7 percent. So it is less than a percentage point decrease in the rate of growth over the 10-year period, as well as the 5-year period that you mentioned.

On Medicaid, the 10-year number is 7.4 percent under current law annual increase, and all of our proposals on Medicaid, which again we believe are all good policy, takes it to 7.6 percent, 0.1 percent.

I would say that is the least—

Senator BUNNING. Out-year projections, am I correct on the out-year predictions?

Mr. PORTMAN. Yes, you are, sir. You are correct. In the out-years it has a greater impact. In the out-years the $32 trillion unfunded liability in Medicare over the 75-year period that was talked about earlier would be reduced by roughly 25 percent or $8 trillion under the full implementation of these Medicare proposals because the savings grow over time.

Senator BUNNING. I have to get back to Social Security because you were on my subcommittee over in the House, as chairman and he was a member of my subcommittee in the House on Social Security.

How many times did I say we have to change the law if we want to change the unified budget? Because the law requires exactly what we do with our money when we take it in in Social Security.

I do not know how many people up here at this forum or this table, this wonderful Budget committee I sit on now, are willing to change the law and do something else with the receipts of the Social Security funds.

But if we are going to change that then the unified budget would look different? Is that correct?

Mr. PORTMAN. That is true. Under current law there is a requirement that they be invested in treasuries.

Senator BUNNING. And what do we do the other money that is invested in treasuries? In other words, the money that the Treasury sells out on a monthly or bimonthly or quarterly or whatever, the 5-year notes, the 2-year notes, the 10-year notes, the 30-year bonds. What do we do with that money?

Mr. PORTMAN. It is used to help finance our debt.

Senator BUNNING. Yes.

Mr. PORTMAN. I will say there is a big distinction between publicly traded debt, which is the debt that we offer to the public, and so-called internal debt.

What you are talking about is the importance of looking at both of those. The internal debt is the obligations that we have to Social Security and beneficiaries over time, now in a surplus. But in 10 short years, as you know, the line crosses. In a sense, we do not have the payroll taxes coming in to afford the—

Senator BUNNING. No, we go into the interest and in about 2046, if we do not do something dramatic, we will be paying 75 percent of the benefits that we now are obligated to pay under current law.

Mr. PORTMAN. But in 10 short years that surplus is no longer there.

Senator BUNNING. That is correct, we are into the interest.

Thank you very much.

Mr. PORTMAN. Thank you, Senator Bunning.

Chairman CONRAD. Thank you, Senator Bunning.

Senator CRAPO.

Senator CRAPO. Thank you very much, Mr. Chairman. And Mr. Portman, we appreciate you being here.

I look back with fondness on the time we served in the House together, as well, on a number of these critical issues where we struggled then to try to find solutions to develop a path forward.

But I want to pursue with you a little further the same line of questioning that you have gone through here with Senator Gregg and Senator Bunning, the 75-year outlook on our entitlements.

I understand that we have gone over the numbers several times, that you are proposing about a $90 billion reduction in the first 5 years, in the 5-years of this budget, but that that $90 billion reduction will translate into approximately $8 trillion of savings over the next 75 years of the entitlement programs that we are talking about; correct?

Mr. PORTMAN. That is correct.

Senator CRAPO. Could you give us a little more detail about how that $90 billion is proposed to be achieved in terms of the savings?

Mr. PORTMAN. Thank you for asking. I had an opportunity with Senator Gregg to talk about this a little bit earlier. But in the first five and 10 years, the majority of the Medicare savings do come from what we believe are changing the payment from what it currently is projected to be to providers to what we think is a more appropriate payment. That number is on the market basket, which is the biggest part of it, a 0.65 percent reduction. We come at that number in part from analysis that has been done by outside groups and experts. But also it happens to be about half of the productivity gain that is expected.

In other words, through efficiencies and more productivity, we would expect about twice that amount. So we think the 0.65 percent is reasonable, again also based on what many experts have given us in terms of the actual health care provider community and what would be an appropriate level. So we think it is good policy and in the first five or 10 years it is the majority of the relatively small savings relative to the growth of the program we talked about.

Over the longer haul, it is shifted somewhat more to the means testing side so it becomes, I believe, nearly half of the savings over time is telling those individuals who make over $80,000 a year or as a couple over $160,000 a year that the Federal Government will continue to provide a subsidy for their premiums under both Part B and Part D, but a little less of a premium subsidy from the Federal Government.

That is the proposal that Senator Conrad talked about the Finance Committee has taken up in the past, maybe the distant past now, and we think is also a crucial element to a comprehensive plan to looking at our entitlement problem.

I will also say we have not talked as much about Social Security. I know you have a strong interest in that and you have been out front on some specific proposals in that regard. The 75-year projection on the Social Security unfunded obligation is $15 trillion. So less we only focus on the Medicare $32 trillion, there is also a big unfunded obligation in our Social Security program.

Senator CRAPO. And we still need to deal with that, which is not done in this budget proposal.

Mr. PORTMAN. No, it is not.

Senator CRAPO. Back to the details you were just talking about, if I understand them correctly then, with the exception of those reductions or changes in the benefit structure for the more wealthy citizens, there is not a proposed change to the benefit structure of the Medicare or Medicaid system?

Mr. PORTMAN. That is correct. For those Medicare beneficiaries who are not part of what is now 5.6 percent of beneficiaries under Part B or 2.7 percent of beneficiaries under Part D who would be subject to some of this slight reduction in the Federal subsidy on premiums, for the rest of Medicare beneficiaries, meaning the vast majority of beneficiaries, the impact is a slight reduction in their premiums. Why? Because they pay 25 percent under Part B, as you know, of the premium, the Federal Government pays 75 percent. And they are going to see a little lower premium as a result of these changes that we have proposed on the provider side.

So for most beneficiaries, the difference will be that they will see a slightly lower premium.

Senator CRAPO. So the message there with regard to the beneficiaries is that the proposals you are making will actually have a slight reduction, except for the small number we talked about at the higher end, and that they could look for about a 25 percent reduction in the long-term issue that we have.

Mr. PORTMAN. That Is correct.

Senator CRAPO. Let us look at the provider side. Are the proposed reductions on the provider side going to cause a problem in terms of providers being able to effectively work in a market that we are seeking to have them work in to provide these benefits?

Mr. PORTMAN. That is a fair question and, again, we have done our own analysis. You will do more analysis in the Finance Committee and here on this committee. Our belief is that we can continue to provide the kind of care that is currently available because we think, again, the 0.65 percent reduction is a fair reduction. It right-sizes, in effect, what the payments have been.

It is also very similar, as you know, to proposals that this Administration has made in the past. The Clinton Administration made proposals of a similar character, but before us. On a bipartisan basis in 1997, we did a lot more in terms of the market basket. Instead of 0.65 in 1997 the number was 2.7 percent as compared to 0.65 percent, which is the chart I showed earlier. Either in nominal terms or as a percent of the program, we have done more as a Congress previously when we have tried to work together to get to a balanced budget.

We also did more in 1993 and 1990 with the OBRA reforms to try to get at a growing deficit.

I know it is not going to be easy. Politically, it never is. But I do believe that this is the appropriate policy approach. I also believe that it is a first and important step toward dealing with this unfunded obligation that Senator Gregg and Senator Conrad talked about.

Senator CRAPO. Thank you, and our time is up.

I just want to thank you for paying attention to that, because I did note, and we all in America noted, that the President has proposed a budget that moves to balance in the year 2012. And I would expect that any other budgets that this committee may come up with will also balance, because we have the dynamic in the short term, the five to 10-year range term, to be able to do that.

But the real looming liabilities out there, those unfunded liabilities that are going to start driving deficits in the future and driving debt in the future have to be paid attention to.

And I appreciate the fact that while submitting a 5-year budget that balances, the President also has made proposals for how we will start dealing with the long-term liabilities that are such a giant issue for our country.

So thank you very much.

Chairman CONRAD. Thank you, Senator.

Senator ENZI.

Senator ENZI. Thank you, Mr. Chairman, and I want to thank the Director for his fine presentation and his capability for answering our questions.

The Higher Education Act is going to be up for reauthorization this year, and I do want to work with the Administration through that reauthorization process and support many of your spending initiatives, particularly the increase in the maximum Pell Grant award. But I do feel that it has to be responsibly paid for. And I am sure several of us have some concerns about mandatory savings being used for discretionary spending.

And rather than have you give me the details right now on how that proposal is going to work, I am going to submit that question in writing for you because I think it is more than what we can do in the time limit here.

But I am drastically interested in that.

I would also ask unanimous consent that a full statement be put in the record.

Chairman CONRAD. Without objection.

[The prepared statement of Senator Enzi follows:]

Statement of Michael B. Enzi

Senate Budget Committee Hearing:
The President's Fiscal Year 2008 Budget Proposal
February 7, 2007

I would like to begin by thanking Budget Committee Chairman Conrad for holding this hearing today. I also want to thank Director Portman for taking the time to testify before this Committee.

As an accountant, fiscal matters fascinate me so I'm probably one of the few people who genuinely look forward every year to reading the President's budget. I view the President's budget submission as his fiscal blueprint for our nation. It is a good starting point to kick-off congressional discussion about the fiscal year 2008 budget resolution.

As we begin this debate over FY 2008 spending, I want to encourage everyone who is interested in this process to remember that the document that we are talking about today is the first step in a lengthy process. Although it is important to take the President's proposal into consideration, it is Congress that ultimately controls the purse strings. The final appropriations or authorizing language may look remarkably different from President's language discussed today.

I wholeheartedly agree with the President's top three priorities in this budget – keeping the economy strong, spending taxpayer dollars wisely and combating terrorism and protecting the homeland. I am particularly pleased to see that the President is committed to balancing the budget by 2012. If we do not start controlling spending today, we will be leaving a fiscal crisis to our children and grandchildren. As most members of this Committee realize, any attempts to control spending must include entitlement spending reform. Accelerated spending for the nation's largest entitlement programs is beginning to overwhelm our economy's ability to pay for those benefits as the Baby Boom Generation starts to retire. Therefore, I am pleased that the President is engaging in the discussion of entitlement reform through his many proposals in this budget.

I also want to encourage members of Congress as well as the Administration to always be looking for new ideas and new ways to solve our fiscal challenges. Our nation is facing a major economic challenge and everyone involved needs to be thinking of innovative ideas on how to deal with this issue. We can find a way to balance the budget while continuing to invest in domestic priorities.

Many elements of the President's budget reflect a commitment to the creation of new and innovative energy technologies. Specifically, I am pleased that the budget reflects a desire on the Administration's behalf to implement Title XVII of the Energy Policy Act of 2005 by requesting the authority to grant up to $9 billion in federal loan guarantees. It is my hope that the Administration will provide a portion of the guarantee authority to help finance the construction of coal-to-liquids facilities, and specifically, coal-to-liquids facilities in the State of Wyoming. Coal-to-liquids is a proven technology that will help lessen the need for imported oil by providing an efficient and clean transportation fuel.

Coal is our nation's greatest domestic energy source, and Wyoming produces approximately one-third of all coal produced in our nation. In any quest for energy independence, there is no question that coal must have an essential role.

Finally, I would like to mention my continued support for the adoption of biennial budgeting as well as giving the President Constitutional line-item veto authority. I am delighted that the President once again included these two proposals in his annual budget request.

Thank you again, Director Portman for your testimony today. I fully recognize and appreciate the hard work you and your staff must go through to get this budget ready for distribution.

Now I see them in the budget, there are some premium increases that are being proposed. We put some premium increases in the legislation last year and now there are some being proposed for this fiscal year. Again, I will cement that in writing to see why you are proposing them and we need a lot more detail on that.

To actually get to a question, another thing that the HELP Committee is working on is sufficient funding for the FDA to carry out its important mission. I did notice in the President's budget request that there are three new user fees that will be required. These new user fees totaled $53 million. What I noted was that they have not been authorized through legislation, and that is close to half of the proposed increase for the FDA budget.

So it has been typical that the industry would negotiate new agreements, fees, and goals and then set it to Congress and then we would do something with it. Has the Administration discussed these fees, particularly with the proposed generic users in the affected industry?

Mr. PORTMAN. [Nodding affirmatively.]

Senator ENZI. You are nodding your head so I will not ask if not, why not? But are they receptive?

Mr. PORTMAN. You note there is an increase in the FDA funding and that is because we want to assure FDA has the resources to be able to even accelerate some of the approvals that are so important.

We have worked with not just the generic community, but the users in general. And I believe that you will find that certain fees are viewed as acceptable so long as they go back in the system. I will let you do your independent analysis of that, but we have spent the time to talk to some of the users to be sure they understand why we are making these increases that they have asked for, but also to talk about to what extent fees should be part of it.

I think you will find again, as long as the resources are devoted back to the FDA process, that there is more receptivity to it.

Senator ENZI. I appreciate the emphasis, too.

I did notice that the budget included, and these are really small amounts compared to the whole budget, but $30 million for the African Development Foundation. That group is doing such spectacular work at actually getting the money to the people not to the governments and having it absorbed there, but to the people. And they are getting the governments to match whatever we do, which I think has a tremendous impact for the United States and much greater impact than some of the ones we are spending billions on. So I really appreciate that emphasis.

Something of more immediate concern for me though is we passed the Surface Mining Control and Reclamation Act amendment last year. That is abandoned mine land money. That implementation is very important to the State of Wyoming. And I want to ask that you keep me in the loop on that, and the budget does not detail where you are in the implementation process. You may not know that, again compared to the whole budget it is a very significant amount. But for Wyoming it is a huge amount. So I would like to know where that is.

Also the coal-to-liquids technology, I think that will play a huge role in the future of energy for this country. The President placed quite an emphasis on it. And I would like to know if the Administration plans to help move forward with that development of coal-to-liquid technologies as part of the loan guarantee program, and if we are ever going to get that in place?

Again a question you may not be able to answer here but if you would find the answer for me.

I have some other questions of a similar nature that I would like to put in there because that can make a huge difference in where we go with policy. And Wyoming, with its huge coal reserves, is ready to step forward and change a lot of that coal into diesel fuel, which would allow the refineries in this country to concentrate on gasoline.

It is also low sulfur coal, so it meets the criteria for low sulfur diesel. So we want to know where those funds are, as well.

Again, I thank you for being here? My time has expired.

Mr. PORTMAN. Thank you, sir. We will get back to you on every one of those issues. And I want to thank you for working with us on so many these issues, the pension reform last year, the education issues.

I appreciate your working with us on increasing funding for Pell Grants to help low income families be sure they can afford the cost of college. We have about a 40 percent increase compared to 2006, about a 30 percent increase even above what Congress has just increased—at least on the House side—in the long-term continuing resolution there.

And then, as you know, we have K through 12 funding increases, about $1 billion over 2006, and actually about $700 million over again the long-term continuing resolution, which provided more funding for K through 12. And then a $1 billion increase in NCLB.

The focus there is again on lower income students and the schools that serve them. Therefore, there is a $1.1 billion increase in the budget, as you know, in Title I.

So we look forward to working with you. We are prioritizing within our resources.

And I know that you have a strong interest in the PBGC. The reason that we have reproposed—none of these are new proposals, as you know—some of our reforms in PBGC is we still see an unfunded liability there. We still see a gap. It is to try to deal with that solvency issue.

But we look forward to working with you on that, and congratulate you on a good step with the Pension Reform Act, which you and other of your colleagues worked on last year.

Senator ENZI. Thank you. And we did have a great bipartisan meeting this morning of people interested in education on the committee. In fact, that was almost everybody on the committee. We met with Secretary Spellings and found some good ways to make good use of the money that you put in there, and probably a couple of other reorganizations of the budget too.

Thank you.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Director Portman, welcome.

People in my part of the country feel betrayed this morning. As you know, the Federal Government owns more than half of our land. God blessed us with an awful lot of trees. And, historically when those trees were cut, we would get in the form of timber receipts money for our schools and roads.

I wrote a law in 2000 that gave us some semblance of stability. That law has now expired. We have been trying to get the Administration to put forward a proposal that at least has a pulse around here in terms of actually going forward and winning support.

As you know, the Administration has recycled the proposal from last time to, in effect, sell off the crown jewels of this country, our national treasures and our forest land, to pay for this program.

Not one single member of the Senate, Director Portman, not one, not on the Republican side, not on the Democratic side, has been willing to support this in the past. This is a proposal that does not have a pulse.

Now we have closures in the rural part of my State. We are hearing that schools may shut down and we have a real question about whether rural counties in Oregon even going to survive. That is what this is about.

I would like to know when we are going to get a proposal from the Administration that really has a prospect of winning bipartisan support here in the Senate? When you advance a proposal that cannot get even one Senator, even one, that is betraying our part of the United States. We have nowhere to turn in these rural counties where the Federal Government owns 58 or 60 percent of the land.

I think you know me pretty well. I am interested in working with you on a bipartisan basis. We are trying to do that in health care. We are trying to do that in a variety of areas.

But this is unacceptable. Senator Baucus and I have even given you alternatives. So it is not a question of the Administration not seeing any alternatives.

When are you going to give us a proposal that has a chance of winning some measure of support here in the Senate?

Mr. PORTMAN. I can tell you are not very enthusiastic about—

Senator WYDEN. There will be a strong message to follow.

Mr. PORTMAN. This is a new proposal. As you know, it is not the same proposal from last year. It is a new proposal, frankly, because of meetings that I had with you and some other members, but primarily a conversation we had about 9 months ago when I first came on the job. And it is quite different.

I thought you might be more interested in it than you appear to be, because it does not say that there is going to be a sale of what we view as excess Federal lands and then have that money all go into the rural schools.

Senator WYDEN. What is new about it?

Mr. PORTMAN. It says that half of that funding can now go back into acquisition of more important lands that States want to acquire for public use.

So it was an attempt on our part to provide $400 million more than last year for the very schools you are concerned about, and do it in a way that actually we thought would be a lot more attractive not just you but, as you say, to your colleagues to be able to work through it.

So let's sit down again. This proposal, we may not have explained it to you properly yet. We will do that in person. Half of the land sales, again, go to county payments and half will go for national forest acquisition in the States.

The counties benefit because they get four additional years of payments and the States receive a big environmental benefit because they get to exchange land that has very low environmental value for lands that have high environmental value. It seemed to us that that made sense.

The parcels to be sold have already been identified as suitable for sale or exchange because they are isolated land or they are difficult or inefficient to manage. The lands with higher environmental value will not be offered for sale. Acquisitions would focus on parcels that enhance the environmental integrity of our national forest. That is a change from last year.

So we will continue to work with you on it. We want to see an extension. We want to see that it is paid for by some mutually agreeable offsets. We think we have a better proposal this year for purposes of passage.

Senator WYDEN. You are a hiker and an outdoorsman. I can tell you when you are talking about selling off lands within the Mt. Hood National Forest—

Mr. PORTMAN. And buying more important plans for Mt. Hood or other important parks or Forest Service system, so it is not the old proposal. It is a new proposal.

Senator WYDEN. But it essentially involves something which is going to be a full employment program for lawyers. You are not going to get any support here. There is going to be lots and lots of litigation while schools, law enforcement, and other essential services close.

My biggest regret with this program is I wish I had kept my hold on every one of those Administration appointees. I took it off last year because I thought the Administration was going to work with us in a good faith. I think these counties now, we have Curry County, Grant County, a whole host of them that are looking at closing. There is a real question about whether they are going to survive. I hope that and I, in fact, challenge you to find somebody here in the Senate who is going to support this new proposal. Because it is not new. It is essentially a recycled version of what we had before. It will get no more support.

That is why we are going to be sitting here again while all these schools are closing. That is unacceptable to me.

Thank you, Mr. Chairman.

Mr. PORTMAN. Thank you, Senator.

Chairman CONRAD. Director Portman, you said that you have balanced the budget without any tax increase. Isn't that the case? Didn't you testify that you—

Mr. PORTMAN. While permanently extending the President's tax cuts. I will look back at my testimony to see how I described it. I said we do so while keeping taxes low and meeting our Nation's priorities. I talked earlier about the fact that we believe the tax cuts ought to be extended, and we extend them permanently in the budget.

Chairman CONRAD. Are there any tax increases included in your proposal?

Mr. PORTMAN. Net, there is a lot of tax relief, I think about $600 billion net. But there are tax—

Chairman CONRAD. But are there any tax increases?

Mr. PORTMAN [continuing]. Increases and tax relief throughout the budget, as always.

Chairman CONRAD. Where would be the biggest tax increases that are in the budget proposal?

Mr. PORTMAN. Probably fees. We talked about the FDA fee earlier.

Chairman CONRAD. Don't you have a large tax increase built in here for the alternative minimum tax?

Mr. PORTMAN. Well, it will be viewed as a tax increase by middle income Americans if we do not do something to reform it.

Chairman CONRAD. But you have only reformed it—

Mr. PORTMAN. It is current law, as you know. You and I have talked about this.

Chairman CONRAD. But you have reformed it for 1 year but you have not reformed it for 5 years.

We just got numbers. This is the question I want to ask you. We just got, from the Tax Policy Center at Treasury, that this is the alternative minimum tax revenues contained in your budget. This will be felt by people as a huge tax increase, as you know, because they are not paying these taxes now.

Mr. PORTMAN. That is why we need to reform it. I agree with you.

Chairman CONRAD. But you have a 5-year budget here and you reform for 1 year. So this is what they are telling us is the effect. That is a $500 billion tax increase. To be precise, $499 billion.

So when this Administration says, when I hear the President say there is no revenue increase, there is a revenue increase. People out there are about to experience, those primarily in the $100,000 to $200,000 income range, are going to find they are going to be in for a big surprise here. They thought they were getting tax cuts. All the talk is tax cut, tax cut, tax cut. The effect of the alternative minimum tax, as you know, is to explode the number of people who will be swept into the alternative minimum tax, approaching 30 million people a year by the end of this period.

So at least some of what I have heard, not from you—I want to make clear—but from others in the Administration, I think, misrepresents the plan. The fact is to balance, you have substantial expansion of revenues in the alternative minimum tax.

Let me go back to the question I asked before.

And now I see Senator Murray has arrived, so I will defer—oh and Senator Whitehouse, as well. Senator Murray had been here earlier, as had Senator Whitehouse. But Senator Murray had been here first, so we will go to Senator Murray, but then I want to come back to this.

Mr. PORTMAN. I would like to talk to you about it.

Chairman CONRAD. And we will have a chance. I will not leave you hanging out there without a chance.

Senator MURRAY.

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

I apologize for having to leave and come back. It is a busy day here. But I did want to come back. You have been asked a lot of broad questions and I want to go back to the Chairman's opening remarks and share with him my concern about the priorities in the budget. We will have more discussion about that.

I wanted to address a couple of regional issues really quickly and then go to the broader picture. The first one is about BPA. We are again dealing with a proposal from OMB that is going to take funds out of the Northwest economy and direct them to the United

States Treasury. This is not the first time we have been down this road. It is just the latest in a series of proposals to circumvent our regional process and impose a rate increase on BPA customers that would have a huge impact.

We have been down this road before on a bipartisan basis. We have defeated it. We will again and it will leave a $91 million hole in your budget.

So instead of doing this every year, I would just like to ask you today, can I get a commitment from you that we can have a real discussion on this rather than just having a budget battle that you know you are going to send over here and it is going to be defeated?

Mr. PORTMAN. Well, you and I have talked about this in an earlier meeting and I do think, if you look at this proposal, it is different than last year's proposal.

Senator MURRAY. They all are, every year there is nuances. But it is the same.

Mr. PORTMAN. This one drops altogether the debt clarity proposal that BPA was very concerned about, which has been in our budgets in the past. We think it is a significant compromise. So does BPA.

We also, at you are urging—and I think you were right about this—we engaged directly with BPA rather than coming up with our proposal without dialog with them. We have had a lot of dialog with them.

We still do have a fundamental difference that we apply not just to BPA, as you know, but across the Federal Government that when you have these kinds of revenues coming in—and the net secondary revenues have been about $500 million per year—that they ought to pay down some of their debt. It is not putting it into the Treasury. It is paying down some of their debt.

Senator MURRAY. Which they do a regular basis and they keep that commitment without putting our ratepayers responsible for paying off money at the national debt level. So we will have discussions again but I just want you to know, working with senators from Idaho and in the region, Oregon, this is not going to go anywhere again. And it is going to leave a $91 million hole in the budget.

I want to ask another really important home issue. As you know, Washington State, my home State, is home to the Hanford site and the Pacific Northwest National Lab. Both of those were born out of the Manhattan Project, both very crucial.

I think you know, as well, DOE is right now in the process of cleaning up that site. And we have a unique situation of a national laboratory with facilities in the middle of a cleanup site.

In these facilities PNNL conducts a lot of really important work for issues ranging from national security to environmental remediation. We have to make accommodations to continue the cleanup of the Hanford site and still preserve those research facilities.

For the past couple years, I have been working very closely with the Department of Energy and with the Department of Homeland Security in support of a plan to do that. But in the 2008 budget, you do not allow that plan to go forward.

This is a project that relies on third-party financing. It has been very carefully worked out with all parties involved. My understanding is now that OMB is not going to allow that third-party financing package to move forward.

I would like to know from you when OMB is going to allow that to happen?

Mr. PORTMAN. I apologize, I do not know the answer to that this morning, and I will get back to you on it. I do know what the numbers are for Hanford which, as you know, is $690 million.

Senator MURRAY. I know the Hanford numbers and I appreciate the Vit plant. We have some concerns, HAMMER was not funded, and things like that.

But the critical issue for us right now is this very important research facility that is in the middle of a cleanup site that we cannot preserve its ability to continue to do important critical national research unless we are able to move forward on this.

Mr. PORTMAN. Is this the Army Corps issue?

Senator MURRAY. No, it is not. It has to do with PNNL, a research facility, located in the middle of a cleanup site. And in order to continue the clean up, the facility has to either be changed or moved, and we need to make sure that the third-party financing moves forward. For some reason, OMB is the one party out here saying they are not going to allow that to move forward, and it is going to either lose critical, critical research for the Nation, or it is going to cause clean up not to occur.

So if you can get back to me on that, I would appreciate it.

Mr. PORTMAN. I appreciate that, Senator. I will get back to you on it.

Senator MURRAY. And then in my last 10 seconds a broader topic, veterans.

We have gone back and forth with inaccurate projections from the VA on how much they need to cover the cost of veterans. As you know, we went through a very bad situation a couple of years ago where they did not tell us what they needed and ended up billions of dollars short that we had to make up in a supplemental.

It was not just us complaining. The GAO did a report. And what they told us was pretty shocking. The GAO told us that the VA had misled Congress, that they concealed funding problems, that they based their projections on inaccurate models, and that they did not adequately plan for the impact of service members from Iraq and Afghanistan.

Now we have an ongoing war. The President is now asking to send more troops over, 48,000. And we are getting a budget from you that many of us are deeply concerned is based on flawed numbers.

How can you expect us to have confidence in the number you have projected when the history tells us that we are not being told the truth about the cost to the VA because of the war in Iraq and numerous other costs that are coming at them?

Mr. PORTMAN. First of all, I think you will be, I hope you will be pleased with the budget because it is a big increase again, 83 percent increase, as you know, over the life of this Administration for VA health care.

Senator MURRAY. Because we beat you up over it.

Mr. PORTMAN. Well, we worked with Congress on those issues over the years, including when I was in Congress. But it is a $6.1

billion increase in VA health care this year. I am sorry, in VA overall, $2.5 billion for health care. That is a 7.4 percent increase on health care fraud. We will give you total transparency and let you know how we are—

Senator MURRAY. I will have my staff get you the numbers, but what we are seeing is that the VA is basing their projections on the number of Iraqi and Afghani soldiers coming back on fewer than they saw last year, when we know more soldiers are going to come into the system.

Mr. PORTMAN. As you know, we are using the new model. We believe that the concern that you raise, which is a legitimate one, has been fixed in this model. We will share all of that with you.

The new model does have an additional obligation on behalf of the VA on health care side, and it is fully funded in the budget. So we will provide you with all that.

Senator MURRAY. We will look forward to seeing all of that.

Mr. PORTMAN. It is based on the new model.

Senator MURRAY. But again, remember, it is not just us that have not been happy with this. The reports that come back that show us that we have been misled and inaccurate models continue to really concern all of us.

We need to make sure we have adequate funding in the budget that we pass out of Congress to care for the men and women who are protecting us, no matter whether we agree with the President or not. And we take that responsibility very seriously.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

I thank her very much for raising, once again, the issue of veterans. She has been extremely diligent on this subject and has been a very strong advocate for our Nation's veterans, not only in the public councils of this committee but in the private counsels of this committee, for a very long period. So she comes to this with credibility.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Ambassador, how are you?

Mr. PORTMAN. Well, thank you. Sorry I did not acknowledge you earlier. We have not had the chance to meet before.

Senator WHITEHOUSE. I had to go to another meeting.

My first question or I guess comment to you has to do with what I heard you saying as I was going out the door, which I think was that unless we do something about the entitlement costs, we are looking at benefit cuts, we are looking at tax increases or we are looking at massive debt explosions.

I would just urge you to add, in your list of ways to cope with the forecast, particularly health care problems we have coming, that reforming the way in which the health care system operates is, absolutely critical. It makes me crazy when I hear people say well, we can only do this with benefit cuts or tax increases or massive debt, because I see a health care system that is so wasteful, so badly designed, so disgracefully counterproductive in so many different ways.

And then to just sit there and say, well, we are going to leave that alone but we are going to cut people's benefits so that we do not have to go to the trouble of fixing it.

Mr. PORTMAN. You are absolutely right. Maybe you did not hear as you went out, unless we make reforms—and I think that is obviously the better alternative.

Senator WHITEHOUSE. Good.

Mr. PORTMAN. You are right on health care.

Senator WHITEHOUSE. Keep that in your focus because it would be a national disgrace if we had to cut people's health care.

Mr. PORTMAN. I think that is a good point. I did not make that point clearly enough, that so much of what drives, as you know, the Medicare and Medicaid numbers is the inflation in health care. And until you get at that problem, it is difficult to get at that larger problem that we have with our obligations going forward.

Senator WHITEHOUSE. The other thing I wanted to talk with you about is I am new to this committee and I am sort of working my way down into the details. But starting at a very macro level, I see major economic shifts happening in our economy that are the result of the, to use the popular word, flattening of the world economy, creating big-time winners and losers in the American economy, very often perhaps even usually, through no particular fault or no particular achievement of their own. They just happened to be in the right place as the economy shifted or caught in the wrong place as the economy shifted.

I see that playing out in the statistics that we all see about the evaporation of the middle class, the increasing income gap between rich and poor, the fact that CEOs make 400 times now the average worker salary and it used to be 40 just a couple of decades ago; that we are headed for what I consider to be considerable social/political/economic problems if we do not do something about this.

And I would like your comment on whether you think that this is a sustainable course. Or alternatively, are there actually social and political consequences to allowing our country to turn into that sort of an almost economic royalist economy, to use a friend's phraseology? And if there really are problems coming at us on that, what should we be doing about it?

Because it strikes me that this Administration's tax policy has compounded the problem by making the people who are the winners, as a result of this really secular shift, even bigger winners and throwing the people who are the losers under this economy even further under the bus.

Mr. PORTMAN. I think you raise a really interesting question about what the impact of the global economy is on winners and users. You are absolutely right, the pace of change is increasingly fast, too. So it is hard for us almost to get ahead of it sometimes. And a lot of it, as you say, is not driven by Government, it is driven by market forces beyond Government.

As you know, I was the Trade Representative before this job so I was more familiar with some of those market forces. They are both a challenge and a huge opportunity.

As other countries grow and prosper, it does not hurt us. It can actually help us because it expands markets for service providers in your State, farmers, manufacturers and so on.

Senator WHITEHOUSE. I am thinking less internationally than domestically.

Mr. PORTMAN. Absolutely, and my point is that it affects our economy a lot and there are winners and losers.

I think the tax policy, and we talked about this earlier when you were out at your other responsibilities, but we talked about the fact that if you put all the President's tax policies from 2001 and 2003 together, the upper income Americans are actually paying a bigger part of the burden.

Now admittedly, they are always paying a bigger part of the burden. And so when you do tax relief across the board, give everybody tax relief, they got tax relief. And more significant tax relief if they were paying more taxes.

But the burden is now, for the top 10 percent for instance, you are talking about 66 percent of our income taxes. It was about 64 percent. About four or five million Americans are off the rolls altogether who are lower income Americans because of the refundable nature of the child credit, 10 percent bracket expanding, marriage penalty and so on.

So I do not think the tax relief has had that impact. In fact, arguably it has shifted the burden more to the upper income Americans.

Senator WHITEHOUSE. It certainly has not offset it, as we can see from the—

Mr. PORTMAN. What would have happened otherwise is something we can look at. We can maybe get you some data on that.

But in terms of wage growth, which is key to this, it has taken a while in this recovery to see real wage growth, partly because inflation was relatively high the last couple of years. But we are now seeing real wage growth, which is a difference. Within the last year we have particularly seen some market increases in hourly wage growth, which is again addressing some of this income inequality issue you are talking about.

I said earlier it is happening a little sooner than it did in the last recovery, in the 1990's. The wage growth now is higher as a percent than it was at this point in our recovery in the 1990's. But it always takes a while to catch up with productivity growth and GDP growth.

And finally in this budget, and you may not like all of aspects of the budget, but I do want focus—

Senator WHITEHOUSE. Nobody has ever liked all aspects of any budget anywhere.

Mr. PORTMAN. I do hope you will focus on the American Competitiveness Initiative, because it is trying to get at this very issue you address, which is a rapidly changing global economy that challenges us to be more competitive than ever in order for America to keep our edge.

Right now we are the envy of the world. We are growing faster than any of the other G–7 countries. So the major developed countries in the world are looking at us saying why do you have lower unemployment than we do? Why do you have faster growth? I think it goes to our entrepreneurial and innovative nature as Americans. But we need to do more as Government to encourage that.

So if you will look in the budget, for instance, we have additional resources for research. We make a commitment to double that over time. We have that again in our budget this year, as we did last year.

Congress, on a bipartisan basis, has been very supportive of that. But it includes everything from the research and experimentation tax credit, the R&D tax credit it used to be called, which I know is important to your State, but also increases in funding for research about American competitiveness, engineering, math, science and so on.

So that is part of the response, I think, that you will see in this budget that we, as a Government, ought to be focused on to address the challenge that you rightly raise.

Senator WHITEHOUSE. But in terms of the dislocation of people who are the losers and the economic shift when having to compete with very low-wage workers in India, Indonesia or China or wherever, in terms of the concern that I just see so deeply in Rhode Island as I travel around, is people really are very, very concerned about their economic futures. And for the first time in their lives, worried that things do not look so good for them and starting to lose their own optimism.

For those people, the message is just hang in there and wait for the economic forces that will ultimately drive wage growth to come to fruition?

Mr. PORTMAN. No, again if you look at our budget, which your colleague Senator Sanders said is a reflection of policy and how we view what the Governmental's role ought to be. Not only do we have these increases in funding for competitiveness, which directly addresses some of the issues you raised in the global economy.

But the reason we have increases in funding in unprecedented levels for K through 12 education is that we see an incredible correlation between education level and that wage gap you talked about and the sense of insecurity that many people feel as a result of, in part, the global economy.

By the way, it is not just the global economy. It is our own economy, because our own economy is increasingly competitive.

We also have resources devoted more toward lower income students within that mix, about a $1 billion increase in Title I here, because those tend to be some of our lower performing schools that would be eligible for Title I.

And then of course, the Pell Grant increase that you know about that you all, I think, are going to vote on soon. We increase that even more. We would have about a 40 percent increase, after you finished increasing it—which we had not expected frankly—for 2007, it will be about a 30 percent increase. But, Pell again focuses more on ensuring that some of those folks who may feel that they are not enjoying all of the benefits of a good economy, at least have more of an ability to be able to afford the higher cost of higher education.

So there are some things in our education part of the budget and the competitiveness part of the budget. Health care, of course as you know, in your State is a huge issue. We have the focus on health care and the uninsured and the cost of health care, which you talked about earlier. Also energy, in the budget reflective of what the President talked about in terms of energy, that our kitchen table issues that I think add to that insecurity.

So we have some proposals here. I know that you will have others.

Senator WHITEHOUSE. Good. I have exceeded my time. Mr. Chairman, my clock in front of me is broken, which I think gives me a bye on any time restrictions.

Chairman CONRAD. You did very well.

Senator WHITEHOUSE. I apologize, Mr. Chairman.

For the record, Pell of Rhode Island.

Chairman CONRAD. No apology required. We knew that it was not working.

The first thing I want to ask you is, Ambassador Portman, Director Portman, will the Iraq war be over by 2010?

Mr. PORTMAN. I do not know.

Chairman CONRAD. The budget says that we do know. The budget says there is no money in 2010.

Mr. PORTMAN. As I said earlier in the response to Mr. Menendez's question, we are showing more war costs, as you have acknowledged, and I thank you for that. And we are showing it in greater detail than we ever have before. We are also showing for 2008 a substantial commitment that is, as I said, effectively a straight line commitment. Secretary Gates, who has been testifying this week—

Chairman CONRAD. That would be for 2008—

Mr. PORTMAN. That is for 2008.

Chairman CONRAD. But then a very sharp reduction for 2009. The President has told us repeatedly there is no timeline. But when I look in his budget, there appears to be a timeline, that the war will deescalate, will dramatically be reduced in activity in 2009. That is what the budget says. It is going to go from $145 billion down to $50 billion. That is a dramatic reduction. And then no spending at all in 2010.

And so it looks to me like, at least with respect to the budget, there is a timeline.

Mr. PORTMAN. We will have to see how it goes. Our hope is that the 2008 supplemental request, which as you acknowledged earlier we have never presented to Congress before, and we have never presented the next year, will end up being high. That is our hope.

Chairman CONRAD. I say, I give you credit. I especially give you personally credit for getting in the 2008 budget something that is far closer to realistic, I believe. But I look in those out-years. When we talk about this budget balancing, I know that that is the assertion. But when I look at the war spending, when I look at the alternative minimum tax, those are big moving parts.

Mr. PORTMAN. Can I make one comment on defense that I know you will appreciate? I am not sure that I can explain this properly, but I will try.

If you look at our 2008 request, you not only see a substantial commitment to the global war on terror through emergency supplemental spending, which is part of the budget but supplemental to the base budget, you will also see in the Department of Defense and in the Department of State substantial double-digit increases in funding.

There is a reason for that, and it relates to the global war on terror and readiness concerns that have been expressed in this Congress on both sides of the aisle.

I am not suggesting that that increase in the base is going to solve every problem. Our international situation will change and we will see what our needs are.

But I will say that in terms of your concern about what numbers do you show in the budget, to have an 11 percent increase in the base funding for defense and have that fully funded within our declining deficit for 2008, and to have an over 12 percent increase in State's budget, much of which is security-related and GWOT-related, does show a commitment on resources that we have not shown previously and is part of our deficit calculation.

And I hope you will note that those are made part of the base, not supplemental. And that was also part of our intent this year, was to provide more in the base to show what we think those costs are.

Chairman CONRAD. And we appreciate that, and I have tried to acknowledge that, both publicly and privately.

Let me just talk about several other issues. There has been mention of Social Security and it would take a law change to do something different on Social Security. No it would not. It would not take any law change.

If we were not running these massive fiscal deficits the money in Social Security would be used to pay down debt. That is a huge difference. If we were paying down this debt instead of adding to the debt, that would be in line with what the intention was when Social Security was changed to prepare for the retirement of the baby boom generation.

They increased the taxes on Social Security for a purpose, and it was to make it solvent long-term. And it was decided to either pay down debt so that we were better prepared for the retirement of the baby boom generation or be able to prepay the liability. Neither of those things are happening.

Instead, Social Security money that is in temporary surplus is being used to pay operating expenses. Now to suggest that some law has to be changed to change that trajectory is just not correct.

With respect to the assertion I have heard repeatedly that the tax code has been made more progressive, I listened to you very carefully and you talked about the income taxes. If you look at payroll taxes and income taxes, and remember the vast majority of Americans pay more in payroll taxes than they pay in income taxes, you get a very different answer. No. 1.

No. 2, it is not surprising on the income tax side that higher income people pay more because their incomes have grown much more rapidly than the rest of the American population. So of course their taxes have grown, even though they have had a disproportionate benefit from the tax cuts.

We indicated in one chart that for 2008 alone those earning over $1 million a year, the cost of their tax cuts is $55 billion for that 1 year alone.

That takes me to the thing I really want to talk to you about, which is long-term we agree the debt of the country will explode absent our action. To your credit, you have come forward with a proposal on long-term entitlements, especially in the health care accounts, in this budget submission.

What I fault you for is at the same time you have come forward with massive additional tax cuts by making permanent all of the tax cuts previously enacted. In fact, the weight of those tax cuts, the cost of them, far outstrip the savings that you have from cutting Medicare and Medicaid, or at least reducing the growth in those accounts.

That is just not a balanced approach. It is just not balanced. And that is the only conceivable way that there is a long-term resolution is if we have savings out of the long-term entitlements and that will have to bear a disproportionate part of the load. I do not dispute that.

But to suggest we do not need revenue to lessen the impact on the least fortunate among us, especially our revenue from the most fortunate among us—and I include myself in that category—is just divorced from reality. It is just divorced from reality.

And there is no way there is going to be a long-term settlement between Republicans and Democrats absent both sides, both sides compromising on their cherished positions. The fact is Democrats do not want to cut or reduce Medicare or the other entitlements. They do not. Republicans do not want to abandon any tax cut. You know what? It takes two to agree. It takes both sides to demonstrate a willingness to break from their fixed position.

And what I am asking you again today is is your side willing to break from their fixed position in which they say not only no tax increases, no additional revenue, but an insistence on more tax cuts?

Mr. PORTMAN. Interesting that we were accused of massive tax cuts and massive tax increases all in the same 45 minute period.

Chairman CONRAD. We are talking two different periods, aren't we? We are talking the near-term and the long-term.

Mr. PORTMAN. No, I am talking about the chart that you held up saying that we—

Chairman CONRAD. That was for 5 years. Now I am talking, as you know, I am talking about the long-term beyond the 2012 period.

Mr. PORTMAN. I am talking about your long-term chart on your AMT chart, saying that we had massive tax increases.

Chairman CONRAD. That was for 5 years. That is the 5-year budget. Now I am talking about the long-term.

Mr. PORTMAN. The savings over the long-term, I do think that it will be difficult politically, as you say, but I also think that there is greater acknowledgment and recognition of it, partly because of your efforts and others.

I also think, and I was very interested to hear what Senator Whitehouse said about the cost of health care relating to that, because it does. So it is reform, but it is also reform that can be outside these systems on health care generally, because that drives so many of the costs now in Medicare and Medicaid, which is our biggest unfunded obligation.

On the revenue side, we have gone through this today in various ways. I will just say that we will be able to show you in this budget short-term but also longer-term that going at roughly our historical level of revenues and somewhat above, because that is where we are in our budget—and this may not be something that all economists who might represent views closer to my side of the aisle are happy about. In fact, I know they are not. In fact, some of them talk to me about this.

As a percent of our economy, our tax burden—

Chairman CONRAD. Quit talking to them.

Mr. PORTMAN [continuing]. Is greater today than it has been historically, and far greater than it was, as you know, a few years ago.

But we have an opportunity, I think, to come together because of the increasing recognition of the problem, because of some solutions that are now out there being talked about, including some that we have.

Chairman CONRAD. Does your budget, long-term, solve the debt crisis that is looming over us? Does it solve it?

Mr. PORTMAN. No, it does not.

Chairman CONRAD. That is the point. Let's be direct with each other. You know and I know—

Mr. PORTMAN. —But it—

Chairman CONRAD [continuing]. It does not deal with it. And the only way we are going to deal with it is if the two sides get together and there is a compromise on both sides.

And the question I keep putting to you is your prepared to really compromise?

Mr. PORTMAN. We are prepared to engage in the debate and the dialog—

Chairman CONRAD. No, no, that is not what I asked. We can debate. That is not getting us anywhere. The only way we are going to get somewhere is to actually compromise.

Mr. PORTMAN. Mr. Chairman, with all due respect, if I put you on the spot as to what you think the conclusion of a dialog would be—

Chairman CONRAD. I have said—

Mr. PORTMAN [continuing]. On your side, I think you would—

Chairman CONRAD. That is what the problem here. I have said I am prepared—

Mr. PORTMAN. I think you would not think that is very productive.

Chairman CONRAD [continuing]. To get savings out of long-term entitlement programs.

What I do not hear from your side ever is that you are prepared to do something on the revenue side of this equation, other than you want more tax cuts. You talk about divorced from reality, that is it.

Mr. PORTMAN. We are not talking about more tax cuts, just to be clear.

Chairman CONRAD. You are talking about making all the tax cuts permanent—

Mr. PORTMAN. That is talking about extending the—

Chairman CONRAD [continuing]. That have a cost of nearly $2 trillion over the next 10 years.

Mr. PORTMAN. Extending the existing tax relief.

Chairman CONRAD. But the law does not extend the existing tax relief. You are coming here asking to change the law to make all the tax cuts permanent, including ones that go overwhelmingly to the most advantaged and the wealthiest among us and with no— and at the same time saying we have to cut things that help the people who are the least among us.

I have to say to you, I do not know of any religion that teaches let us take from the least to give to those who have the most.

Mr. PORTMAN. Again, if you look at the tax relief that we are attempting to extend, in our view this is not only, factually speaking, a more progressive system than it was previously. In other words, the top end is paying a higher burden of taxation thanks to the— and by the way, on the payroll taxes, we have changed nothing. So whatever the policy was in the previous administration and previous Congresses, we have continued.

With regard to the importance of this tax relief to the economy, we feel very strongly that it would be exactly the wrong thing to do right now to abandon the tax relief which we think has been critical to the robust economy that has put us in a position to even talk about balancing the budget.

In going forward, Senator, let's be honest, we are not going to be able, as Senator Gregg has said well, to tax our way to a solution here.

Chairman CONRAD. And we are not able to cut our way, either. The hard reality is you guys have come up here with this line every year and the debt just keeps getting bigger.

Mr. PORTMAN. Let me finish. Part of—

Chairman CONRAD. Look, it has not worked on your side. You promised us in this Administration that the debt would not increase, that in fact the President told us he have maximum pay down of the debt. And the fact is the debt has exploded. Now it has not worked, sir.

And what I am saying to you, unless there is a serious—serious now—I mean we can play these political games all day and all night. And I am disappointed. Because I hoped that this year, with what is so clear in terms of the threat facing this country, that there would be a chance to work together to do what we all honestly know needs to be done which is to work on both, on both the spending side of the equation and the revenue.

And the idea that it is just going to be on the spending side and you are going to have more tax cuts, that is not real. That is not serious. That is not good faith.

Mr. PORTMAN. If I could just finish my point for a second on the importance of the economy side and therefore the revenue side, we have made progress the last couple of years. The reason I mentioned, we have reduced the deficit by $165 billion in the last 2 years is to show that there is a model here and that is the reason we are—

Chairman CONRAD. How much did the debt go up in the last 2 years? The debt went up—

Mr. PORTMAN. Let me answer.

Chairman CONRAD [continuing]. Approaching $1 trillion in the last 2 years.

Mr. PORTMAN. Let me answer. The way economists on the right, on the left, or nonpartisan would react to that question is they would say what matters about the debt is our debt as a percentage of our economy because that is what affects the markets, that is what affects our economy and that is how people look at it.

Chairman CONRAD. Agreed. And it is going up.

Mr. PORTMAN. And as a percent of our economy, it is going down—

Chairman CONRAD. No, gross debt, gross debt in the United States is going up.

Mr. PORTMAN. Publicly traded debt has gone down as a percent of the economy—

Chairman CONRAD. Gross debt is what we are going to have to pay back. And the gross debt is doing up.

Mr. PORTMAN. That is another discussion.

Chairman CONRAD. What used to be—

Mr. PORTMAN. But if you look at the publicly—

Chairman CONRAD. No, no, let's have that discussion.

Mr. PORTMAN [continuing]. Traded debt, because that is the issue here, it has gone down the last couple of years. Why? Because our economy is growing at about 3 percent. Our deficit is growing at about 1.8 percent.

Chairman CONRAD. What does that leave out? What does that leave out?

Mr. PORTMAN. That means we actually have—

Chairman CONRAD. That leaves all of the money you are taking from every trust fund in sight—

Mr. PORTMAN. No.

Chairman CONRAD [continuing]. To float this boat, that is going to have to be paid back.

Mr. PORTMAN. It is publicly traded debt. And at the end of the 12 years—

Chairman CONRAD. But the gross debt is all of the money that we owe. And the gross debt under your plan, when you put back the things you have left out, is growing faster than the economy. The gross debt of the United States has grown enormously in the last 6 years. Do you disagree with that?

Mr. PORTMAN. I do not disagree that the internal debt, if you include that, if you think we should not be reforming any of these programs, and you look at that—

Chairman CONRAD. Did the gross debt of the United States—

Mr. PORTMAN [continuing]. As an unfunded—

Chairman CONRAD [continuing]. Over the last 6 years as a share of the economy?

Mr. PORTMAN. When you include internal debt.

But when you deal with the publicly traded debt, which again is what—

Chairman CONRAD. Do you know what?

Mr. PORTMAN [continuing]. Affects our economy, it has actually gone down because we are making progress.

Chairman CONRAD. But what affects the budget is all of the debt.

Mr. PORTMAN. That is because of two things, a little better restraint on spending and a strong economy, which has record revenues.

My only point is as you get into this discussion on revenues, we have to keep in mind that we are not going to be able, as Senator

Gregg said and you have acknowledged, tax our way through this. We are going to have to make some changes, as you say—

Chairman CONRAD. And we cannot tax cut our way through it, either.

Mr. PORTMAN. But we also need to rely on a strong economy. We cannot grow our way out of the problem. I am not saying that. But it is a critical element—

Chairman CONRAD. Let me ask you this: do tax cuts—

Mr. PORTMAN [continuing]. A critical element to dealing with the long-term problem is to keeping a strong economy.

Chairman CONRAD. Do tax cuts pay for themselves?

Mr. PORTMAN. Some do and some do not. It depends on the tax cuts and—

Chairman CONRAD. No, no, no. No tax Cuts—According to the Treasury Department of this Administration, no tax cuts pay for themselves.

Mr. PORTMAN. Certainly the 1997 capital gains did.

Chairman CONRAD. No.

Mr. PORTMAN. Certainly—

Chairman CONRAD. No.

Mr. PORTMAN. Certainly it did.

Mr. PORTMAN. No. Mr. Mankiw, are you familiar with Mr. Mankiw?

Mr. PORTMAN. I am familiar with Mr. Mankiw.

Chairman CONRAD. Is he part of the Republican administration?

Mr. PORTMAN. Yes. He was.

Chairman CONRAD. What does he say? He says at most the tax cuts paid for 50 percent. Those are the capital tax cuts that you are referring to paid for half. So if you have $100 billion tax cut, you added $50 billion to the deficit. That is his finding.

On those that are not capital tax cuts, he says they only pay for 17 percent of them. So if you have $100 billion tax cut, you get back $17 billion in increased economic activity, you add to the debt $83 billion.

The proof is in the pudding.

Mr. PORTMAN. It depends on the timing.

Chairman CONRAD. We have had this experiment going on and all that has happened is the debt of this country has exploded at the worst possible time, before the baby boomers retire.

Mr. PORTMAN. You and I can have this discussion in detail—

Chairman CONRAD. The Treasury Department—that was Mr. Mankiw.

Mr. PORTMAN [continuing]. But if you look at the timing—

Chairman CONRAD. Let me tell you what the Treasury Department has concluded.

Mr. PORTMAN [continuing]. And the type of tax cut, it can indeed have a salutary effect on revenues. We have seen it. The last 2 years we have had revenue increases because of a robust economy.

Chairman CONRAD. So are you saying tax cuts pay for themselves?

Mr. PORTMAN. No, I explicitly did not say that. What I said was it depends on the tax cut—

Chairman CONRAD. Well, that is a very important distinction.

Mr. PORTMAN [continuing]. And the timing of the tax cut. And I think it is a big risk right now, when we have an economy that again is hitting on all cylinders in terms of employment, wage growth now, GDP—3.5 percent GDP in the first quarter of this year, which no one expected frankly. Ours was 2.7 percent.

Chairman CONRAD. And we are adding $500 billion to the debt.

Mr. PORTMAN. No, we need to be sure that we continue—

Chairman CONRAD. And we are financing the debt—

Mr. PORTMAN [continuing]. To have that economy growing so that Americans can have better jobs, but also so that we can have this revenue coming in to be able to keep reducing the deficit, as we have done the last 2 years. That is a fact.

Chairman CONRAD. Unfortunately, the debt—

Mr. PORTMAN. And getting the surplus under the unified budget is the first good step, and I look forward to working with you on your budget and our budget to get there.

Chairman CONRAD. Let me just say, the debt has exploded. And the debt of this country has exploded at the worst possible time, before the baby boomers retire. And the plan the President has put forward does not fundamentally address where we are headed.

I just say this to you, we have an opportunity here to work together. But the only way I know in human relations for there to be resolution between parties who have different views is for both sides to compromise. And unfortunately, I see virtually none on your side. And I regret that more than I can say.

[Whereupon, at 12:33 p.m., the committee was adjourned.]

PREPARED STATEMENTS

Russ Feingold

Statement by Senator Russ Feingold
Senate Budget Committee Hearing on the President's FY2008 Budget
February 7, 2007

I thank both the Chairman and the Ranking Member for their commitment to fiscal responsibility. Each has demonstrated a willingness to take tough positions, even positions that are unpopular within their own caucus, on behalf of taxpayers. I have been pleased to work with both of them over the years on budget matters, and the Nation is well-served by their leadership.

Thank you also to Director Portman for appearing before the committee today to discuss the President's budget. You have had a long record of public service. I would liken your current job as Director of the Office of Management and Budget as something akin to being a member of a local school board. There are few jobs that are as important or as thankless, especially when having to appear before one of the congressional budget committees.

Mr. Chairman, the federal budget should be a realistic accounting of the government's likely fiscal future. When the President proposes his own budget, we can certainly expect it to reflect his own policies. It is, to a great extent, a document intended to advocate a particular policy path, and to that extent, it shouldn't be bound by the political realities that it faces as it makes its way through the congressional process.

But it certainly should be informed by that process. And at a minimum, to the extent that the President's budget is intended to reflect his policies, it ought to do so accurately.

The budget before us does not do that. Hundreds of billions of dollars in tax and spending policies, supported by the President, and almost certain to be enacted during the budget window, are excluded in his budget.

For example, the President's budget fails to include the long-term reform of the Alternative Minimum Tax, which some estimate will cost nearly $1 trillion over the next decade. If we don't reform that tax, millions of middle class taxpayers will be hit by it. Yet the President only assumes a one-year extension of the current AMT patch. If we extended that relief through the full term of the President's budget, it would add another $90 billion in costs in 2012 alone. Making just that change to the President's budget, and no others, means it will not reach balance.

The President's budget also fails to reflect his Iraq war policy. The funding for the upcoming budget year apparently falls short of what is needed to fund the escalation announced by the President. And funding beyond this year – the so-called placeholder funding –

perhaps is closer to reflecting my position on Iraq rather than the President's position.

Let me observe that if the President continues his current Iraq policy at the level of spending he proposes, then there really is a risk that our troops on the ground will be put at risk.

The President's budget also includes some assumptions about revenue that are much more optimistic than CBO's assumptions, to the tune of about $150 billion in 2012. I fully appreciate the difficulty in trying to project what future revenues are going to be, and I will be interested to see what CBO's estimate of the President's budget will include in this regard.

Without making a judgment about the accuracy of the President's revenue estimate, I will only suggest that we should resist the temptation of letting our desire to reach a budget goal, such as achieving balance in the unified budget, drive the underlying assumptions in the budget.

Thank you, Mr. Chairman.

Jim Bunning

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
THE PRESIDENT'S FISCAL YEAR 2008 BUDGET PROPOSAL

7 FEBRUARY 2007

Thank you, Mr. Chairman.

On the whole, I was pleased with the budget that has been presented to us by the President this year.

We have been given much food for thought regarding our ten year budget outlook. C.B.O. recently told us that spending for just Social Security, Medicare and Medicaid will equal over 8% of G.D.P. this year. That number is expected to grow to almost 11% by 2016. These three programs currently account for over 41% of the federal budget and that number will rise to almost 57% in 10 years.

We spend most of our time on this committee talking about discretionary spending. But we must never lose sight of the fact that discretionary spending accounts for less than half of the total federal budget. The entire budget is the responsibility of this committee and we must keep the entire budget in mind this year, as we have in years past.

I am very pleased that the White House is taking the challenges of entitlement spending seriously. While I have not yet had an opportunity to examine in full the details of the changes to Medicare and Medicaid that have been proposed in this year's budget, I must commend the Administration for tackling this issue head on and not skirting from making tough choices. As a member of the Senate Finance Committee, as well as the Budget Committee, I commit to examining the proposals in this budget thoroughly with an eye toward making changes that will improve the path we now face in the area of entitlement spending.

In addition to Medicare and Medicaid, Congress must also take a hard look at our Social Security system and make some reforms. In just over a decade, Social Security will begin paying out more in benefits than it collects in revenue. By the year 2041, the program will be insolvent. Without any reforms, the current system has an unfunded liability of over ten trillion dollars. We owe it to our children and grandchildren to have an honest debate on this issue and put this program on a financially sound path.

I thank Director Portman for the hard work and dedication of his office and for his willingness to appear before us today to explain the most recent analysis in detail.

Thank you.

ANSWERS TO QUESTIONS SUBMITTED

Questions for the Record from
Senator Russ Feingold
Senate Budget Committee

Question: How does the President's FY 2008 budget request, as well as the upcoming supplemental, address the continuing rebuilding needs facing Gulf Coast residents, particularly in the area of permanent, affordable housing assistance?

Answer:

The Administration is committed to rebuilding the Gulf Coast. The Federal government has committed $110 billion for the recovery effort to date, and more than 75 percent of that has been obligated to date. Actual reconstruction, however, continues to be a locally-driven community process, which is then coordinated into overall state plans. A tremendous amount of work still lies ahead, and the Federal government continues to support and strengthen, but not replace, State and local government and private initiatives.

The Budget proposes $3.4 billion in supplemental funding for FEMA's Disaster Relief Fund to allow FEMA to continue providing housing assistance, public infrastructure repair grants, and other disaster recovery needs through 2007.

The President recently announced plans to extend FEMA's temporary housing assistance programs for an additional six months, through August 2007, with projected costs of over $500 million. During this extension period, FEMA will be working with the Gulf Coast States and other federal agencies to determine an appropriate path forward for hurricane victims who require further assistance.

$16.7 billion in Community Development Block Grant (CDBG) disaster funds was appropriated in response to the Gulf Coast hurricanes, of which only $1.2 billion has been spent. While there are no additional funds in the FY2008 Budget Request specifically for permanent, affordable housing assistance in the Gulf Coast States, the States are allocating some of the appropriated $16.7 billion in Community Development Block Grant supplemental funds for this purpose. In particular, there is a $1 billion set-aside of CDBG funds targeted for repair, rehabilitation, and reconstruction of the affordable housing stock. HUD also continues to work with state and local governments on rebuilding public and low-income housing.

Question:

I want to touch on reforming the Corps of Engineers. I thank the Administration for its support over the years. The Administration has supported reforms in each of the President's budgets for the Corps, in your Statement of Administration Policy on last Congress' Senate WRDA, and by supporting my independent review and prioritization amendments last July.

The President's budget again makes it clear that there is not enough money to construct all the projects in the Corps' enormous project backlog. This is the reality, despite the joke turned common day practice that if you need money, you go to the Corps. We need to get a handle on this situation. We also need to ensure the Corps is building sound projects and mitigates for any associated environmental damage.

Will the Administration continue to support reforms and come to the table and work with me, Senator McCain, and the authorizing Committees to ensure the inclusion of meaningful reforms in the next WRDA?

Answer:

Yes. The Administration would be happy to work with you, Senator McCain, and the authorizing Committees to enact legislation that will help to improve the performance of the Corps.

Question:

The Budget discourages childless adults from being covered under the State Children's Health Insurance Program (SCHIP). I'm concerned that this will lead to a policy of not covering any adults with program funds. My state of Wisconsin covers parents of Medicaid and SCHIP children in addition to pregnant women. There is excellent evidence that family-based coverage is better for children and families, and there is no other affordable insurance for these adults.

Does the President support states being able to cover these adult population groups under SCHIP? Would the Administration support states like WI continuing coverage of adults with SCHIP funds?

Answer:

The FY 2008 Budget does nothing to jeopardize current SCHIP coverage levels for adults. Under the FY 2008 Budget proposal, States can continue to cover certain populations of adults, particularly parents and pregnant women. The Federal match rate for parents will be slightly lower than the current enhanced match rate. However, reimbursement for these populations will average over 50 percent. The FY 2008 Budget will prioritize SCHIP resources on the population for which it was originally intended – low-income, uninsured children at or below 200% of FPL.

Question:

The President requested only $4.8 billion over five years in additional funds for SCHIP allotments. I understand the Finance Committee estimates that in order to keep existing enrollees covered it would cost at least $15 billion over five years.

Do you agree with the Finance Committee estimates?

How many children and individuals do you estimate will be dropped from the SCHIP rolls under the President's Budget request?

Answer:

The Administration is committed to reforming the allocation of SCHIP funds among States to increase program efficiencies by better targeting funds to states most in need. The $15 billion estimate is too high because the current program financing structure, which gives States three years to spend funds, prevents the timely and effective allocation of funds to states. Under the Administration's proposal, the allocation of funds would be reformed and the amount needed to maintain enrollment would be less that the $15 billion estimate. The Federal match rate for different populations would also vary to focus the majority of Federal funds on children at or below 200% of FPL. According to the HHS actuaries, the Administration's FY 2008 reauthorization proposal, which would increase allotments by $4.8 billion, is sufficient to maintain priority levels of SCHIP enrollment.

Question:

As you may know the current extension of the Milk Income Loss Contract (MILC) program expires one month shy of the end of the current Farm Bill, meaning the Farm Bill baseline will not assume any funding for the program. In October 2004, when the President was campaigning in Wisconsin, he promised on at least two occasions that he would support the MILC program that provides countercyclical support to dairy farmers when the prices are low. Despite those promises, the President's budget cuts the support rate for MILC over time and reduces coverage to only 95% of dairy production. Compared to the program he promised to support when he was in Wisconsin in the fall of 2004, the new program would provide 64 percent of the benefits in FY 2008, and drops to 38 percent by FY 2013.

Why does the President's budget and longer term goals for agriculture make such deep cuts to the MILC program, while other commodities, such as cotton, are projected to receive a more than 20% increase of several hundred million dollars per year?

Answer:

The President fulfilled his commitment to extend the MILC program by two years by proposing legislation to achieve that goal and signing into law an extension of the program. The Administration is now proposing to go beyond that commitment by extending the program an additional 10 years, although at a declining level.

The Administration's proposed reforms were designed to be equitable across commodities. As you may know, the Administration's proposal would reduce loan rates for all of the program crops. The same approach was applied to the MILC program, reducing the payment rate from the full 34 percent to 20 percent over time.

In the proposal, MILC payments would be based on 85 percent of the three-year average of milk marketed during fiscal years 2004-06. This policy change would make the MILC program consistent with the other farm bill counter-cyclical programs that are calculated on historical production bases.

MILC payments would also count towards a producer's overall counter-cyclical payment limit of $110,000 annually, and the new adjusted gross income eligibility cap of $200,000 annually would also apply.

Questions for the Record from
Senator Bill Nelson
Senate Budget Committee

Question:

Funding for NASA remains well below the 2005 authorization level that Congress passed. I plan to work with my colleague to increase this funding through the appropriations process to ensure NASA can continue to meet its main missions.

While NASA did receive a fairly sizable increase relative to other non-security discretionary spending in the budget, I remain concerned about what will happen in future funding years. With budget detail only going through FY 2008, but significant non-security discretionary spending cuts assumed in the budget – only 1 percent increases per year for the five-year budget window – I am curious to know how you anticipate NASA will be treated in these outyears?

What commitment and priority will NASA be given, or can we expect NASA will see only the 1-percent increases assumed in the rest of the non-security discretionary budget from FY2009 to FY 2012?

Answer:

I can assure you that the Administration's support for NASA and the vision for space exploration remains a priority in the outyears. For planning purposes, the budget assumes the following outyear funding for NASA after 2008:

2009 $17,614 million
2010 $18,026 million
2011 $18,460 million
2012 $18,905 million.

Question:

Restoration of the Everglades ecosystem is a huge priority for me, and for the state of Florida. In fact, the state has continued to live up to its obligations in acquiring land and supplying necessary infrastructure to further restoration projects.

Unfortunately, I don't believe the President's budget shows the necessary level of federal commitment to get this job done. In particular, the Comprehensive Everglades Restoration Plan (CERP) is significantly under-funded in his submission, just at a time when construction ought to be starting on a number of projects in the region.

At what percentage of capability is the Comprehensive Everglades Restoration Plan (CERP) funded under the Administration's proposal? What impacts will this level of funding have on the timeframe for reaching benchmarks in Everglades restoration?

Answer:

The Administration has designated the overall Everglades/South Florida ecosystem restoration effort as a national priority, and has funded this effort accordingly. The Budget used performance-based criteria to allocate funding among the projects in the civil works construction program. Using these criteria, the Budget included $162.4 million for the Everglades/South Florida ecosystem restoration program for FY 2008. This is roughly the same as the $164 million that we requested for FY 2007, and a substantial increase above the FY 2006 enacted level of $137 million.

For FY 2008, the Corps allocated $98.4 million of the $162.4 million to work outside of the CERP, which is 81 percent of the maximum that it estimates it could efficiently and effectively spend, and $64 million of the $162.4 million to work under the CERP, which is 58 percent of the maximum that it estimates it could efficiently and effectively spend.

The Corps and the Department of the Interior are working with the State of Florida to develop interim goals and targets to track progress on restoring the ecosystem. The Budget includes the funding needed to support continued development of these benchmarks. The CERP is part of the larger restoration effort and is inextricably connected to it. Achieving ecological success will require addressing a number of scientific uncertainties and overcoming the technical challenges, and will depend on how the Corps formulates the principal restoration features and how it operates them, and as well as an appropriate level of funding in the out-years.

Questions for the Record from
Senator Mike Enzi
Senate Budget Committee

Question:

I am pleased that the budget reflects the passage of the Surface Mining Control and Reclamation Act Amendments of 2006. Because implementation of this bill is so important to the State of Wyoming, I want to be involved as the Department of the Interior and OMB moves forward, so I hope you will keep me in the loop.

The budget does not detail where you are at in the implementation process. Can you provide me with an update?

Answer:

Thank you for your question. The Department of the Interior's (DOI) Office of Surface Mining and Reclamation Enforcement (OSMRE) anticipates issuing a Memorandum of Understanding with the Department of Treasury regarding how States and Tribes should receive payment of amounts equivalent to their balances in the Abandoned Mine Reclamation Fund, as required by the recent amendments.

OSMRE is also currently determining how several key provisions should best be implemented. It anticipates issuing certain necessary rules by late September 2007 including, for example, how to reclassify the reclamation priority of certain abandoned mine lands and how to establish Tribal primacy under the new law. Additionally, OSMRE continues to refine its cost estimates as it furthers its understanding of the amendments and receives updated information from stakeholders.

Question:

The Higher Education Act is up for reauthorization this year. I want to work with the Administration throughout the reauthorization process, and support many of your pending initiatives – particularly increasing the maximum Pell Grant award, but feel strongly that any new spending must be responsibly paid for.

I, along with other Senators, have concerns about using mandatory savings for discretionary spending, such as Pell Grant programs. Could you explain your proposal in more detail?

Answer:

The Administration is proposing to raise the maximum Pell grant award to $4,600 in 2008 and to $5,400 in 2012. This increase is fully paid for with mandatory reductions in the student loan programs. The President's Pell Grant proposal provides a specific level of mandatory BA solely to pay for the estimated costs of increases above the annual discretionary appropriation. Congress and the Administration would still retain full control of annual Pell Grant discretionary spending. The Administration would oppose making the entire Pell Grant program mandatory.

Question:

What are the premium increases that you are proposing for the PBGC this fiscal year, and why are you proposing them?

Answer:

The 2008 Budget re-proposes the premium reforms from the Administration's comprehensive pension reform proposal that were not included in Pension Protection Act of 2006, including:

- Authorizing PBGC's Board of Directors to adjust the variable rate premiums paid by underfunded pension plans.
- Extending the variable rate premium to a plan's non-vested as well as its vested liabilities.

These reforms will generate $10.6 billion in savings over ten years, improving PBGC's financial condition and safeguarding the future retirement benefits of American workers. Last year, President Bush asked Congress to strengthen protections for the pensions American workers rely on, and Congress responded by passing, with bipartisan support, the Pension Protection Act, which made sweeping reforms to the retirement system. The legislation strengthened the pension insurance system and significantly expanded opportunities to build retirement nest eggs.

However, the Pension Protection Act did not make the defined benefit pension system solvent. Further reforms are needed to address the $19 billion gap that still exists between the PBGC's liabilities and its assets and reduce the risk of a taxpayer bailout.

Question:

As Ranking Member of the HELP Committee, I strongly support sufficient FDA funding to carry out the agency's critically important mission. However, I note that in order to meet the President's budget request, three new user fees would be required. These new user fees total $53 million, but have not been authorized through legislation. This is close to half of the proposed increase for FDA in the budget.

In the existing user fee programs at FDA, FDA and the regulated industry typically negotiate out a new agreement on fees and goals, and the agreement is then sent to Congress for review. Has the Administration discussed these fees, particularly the proposed generic drug user fees, with the affected industries? If not, why not? If so, are they receptive?

Answer: The Administration shares your interest in an efficient, effective Food and Drug Administration (FDA). We believe that the new user fees proposed in the FY 2008 Budget will help the FDA continue to achieve the agency's public health mission.

The Administration had not discussed the proposed user fees with those outside the Administration prior to submission of the FY 2008 Budget. As you know, all budget information is considered pre-decisional within the Administration until the budget is transmitted to Congress. We are looking forward to working with the regulated industry, Congress, and other stakeholders to enact the proposed user fees.

The FY 2008 Budget proposes $15.7 million in new generic drug user fees. These fees will enable FDA to shorten review times and begin to address the growing backlog of pending generic drug applications. We anticipate that the industry will be supportive of the proposed fees, and we look forward to discussions with the industry and Congress.

Question:

"I noted that the budget request includes $30 million for the African Development Foundation and that the Foundation uses its appropriated funds to secure matching funds from its development partners, particularly African governments. I have been pleased with the progress the ADF has made in Africa and believe it is one of the most highly effective developmental programs the United States is currently funding.

Do you believe this type of development program where matching funds are secured could be used as a prototype to improve currently ineffective development programs? Would the use of matching funds from the private sector for this type of program help the United States achieve a balanced budget by 2012?"

Answer:

I am also very supportive of ADF's approach to small business development and grant-making in Africa.

I agree that there are lessons to be learned from ADF's business model that could be applied to other development programs and the Administration is applying these lessons to other assistance areas whenever and wherever this model is appropriate.

There is certainly recognition that leveraging contributions from reeipient governments, and also from private sector partners and other donors, can increase the impact of our foreign assistance resources while reducing the burden on our budget and supporting deficit reduction.

Question:

I am pleased that the budget includes a substantial request to implement Title XVII of the Energy Policy Act of 2005, which deals with federal loan guarantees. I have been a strong supporter of this section and am pleased the Administration sees the value in helping the development of new technologies.

One technology that deserves strong consideration is coal-to-liquids technology. Because coal is our greatest energy resource, it must be central to any effort to become energy independent. Coal-to-liquids technology has the potential to replace a substantial amount of transportation fuel.

Does the Administration plant to help move forward the development of coal-to-liquids technologies as part of the loan guarantee program?

Response:

In implementing Title XVII of the Energy Policy Act of 2005, the 2008 Budget proposes a $9 billion loan volume limitation in FY 2008 for innovative advanced technologies that will: 1) promote energy security; and 2) avoid, reduce, or sequester air pollutants or anthropogenic emissions of greenhouse gases. The statute also requires that projects employ "new or significantly improved technologies compared to commercial technologies in service".

This year's budget proposes to concentrate on two categories of technology that correlate with the goals of the President's Advanced Energy Initiative: technologies to reduce or displace oil demand, or technologies that change how we power our homes and businesses. Coal to liquids technology would fit in the first category. Of course, each proposal will be evaluated separately to determine how well it meets the goals of the program, its technical merit, and its financial merit.

Sen. Crapo
FY 2008 Senate Budget Committee
Questions for the Record

Question:
Currently the Crime Victim's Fund brings in estimated annual receipts around $600 million, and spends between $600 and $700 million on victims' compensation and assistance activities. This year, the President's budget proposes the permanent rescission of growing accumulated surplus balances in the Crime Victim's Fund totaling $1.338 billion, and to fund the Crime Victim's Fund with general fund appropriations to be paid back out of the fines collected this year.

Is the President's position that yearly receipts from criminal fines and penalties will be enough to sustain the victim's compensation and assistance programs each year without transferring the burden to the taxpayer or sacrificing victim's services?

Answer:
I appreciate your concern about sustaining the crime victims' programs and doing so without adding to the burden of the taxpayer. The Budget does propose to sustain the level of funding for crime victims' programs in 2008 without transferring any burden to the taxpayer. I cannot promise that every year will see sufficient collections of criminal fines and penalties to maintain spending for crime victims. However, in four of the six past years, deposits and recoveries (net inflows) for the Crime Victim's Fund have greatly exceeded the spending (outflows) of the Fund, and for a fifth year, the inflows were very close to the level of spending. In only one year, 2003, has the Fund significantly drawn on balances. With this kind of track record, we expect that the future will be the same.

In most years, the Fund will experience greater net inflows than it does outflows. If, on occasion, we need to transfer funding from the General Fund in order to provide for crime victims compensation and services, that is a much smaller net burden to the taxpayer than continuing the use of a budget gimmick that allows the Crime Victims Fund's excess balances to be used each year to offset (pay for) $1.3 billion in completely unrelated spending. These are dollars that, in all likelihood, would have been saved—not spent on what, by definition, are not our highest priority programs—if not for the use of the Crime Victim's Fund as a recurring budgetary gimmick.

Question:

Does the President's proposed rescission take into account the potential shortfall resulting from delayed collections of criminal penalties, and if not, how do you propose the situation be dealt with?

Answer:

There is always a risk of a potential shortfall in collections of criminal penalties, although we believe, as I have indicated above, that it is a small one.

Question:

What is the President's response to the assertion by victims' advocacy organizations that Congress intended to have the fund kept only for victims' compensation and assistance and never moved to the General Fund?

Answer:

The Administration is not proposing to change the key element that finances most Federal funding for crime victims compensation and services programs – the use of criminal fines and penalties. I am also confident that the Congress, when it established the Crime Victims Fund, did not foresee that the Fund would accumulate $1.3 billion in balances that are allowed to roll forward each year and serve as an offset to permit higher spending for purposes completely unrelated to crime victims. We expect the deposits of criminal fines and penalties to sustain most spending for the crime victims programs for the foreseeable future. What we do not wish to see continue is the perpetual use of excess balances to justify other, unrelated spending within the budget.

Question:

We know that the oxygen community has taken some pretty big hits of late, with a new payment structure effective at the beginning of this year, and they still will be living with the reality of competitive bidding later this year. Would you be open to discussions with the pulmonary physician and oxygen user groups to structure a revised payment system that was based on actual clinical need of the patient AND achieved savings similar to your targets?

Answer:

We are always happy to discuss our proposals and alternatives that might be offered. I would note that together, Congress and the Administration have taken a number of steps to better align Medicare payments for durable medical equipment (DME) such as oxygen equipment with costs and beneficiary needs.

Even with these changes, however, there is evidence that Medicare and its beneficiaries are seriously overpaying for oxygen equipment. According to a 2006 HHS Inspector General report, Medicare will allow $7,215 for 36 months for concentrators that cost $587, on average, to purchase. The report also states beneficiaries' coinsurance for a 36-month rental is more than twice the average cost of a new concentrator.

Total payments for this equipment are not significantly different under the new payment structure. Our Budget proposes additional measures to better align payments for oxygen equipment with costs and need. This not only means savings for beneficiaries and taxpayers, but access to equipment for the period the beneficiary actually needs it.

Our Budget proposes no changes to payments for new oxygen generating portable equipment, or to payments for needed service and maintenance. Also, in contrast to last year, this year's proposal would not permanently transfer title of oxygen equipment to the beneficiary at the end of 13 months.

THE PRESIDENT'S FISCAL YEAR 2008 BUDGET AND REVENUE PROPOSALS

THURSDAY, FEBRUARY 8, 2007

UNITED STATES 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, Nelson, Menendez, Cardin, Sanders, Whitehouse, Gregg, Domenici, Bunning, and Crapo.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

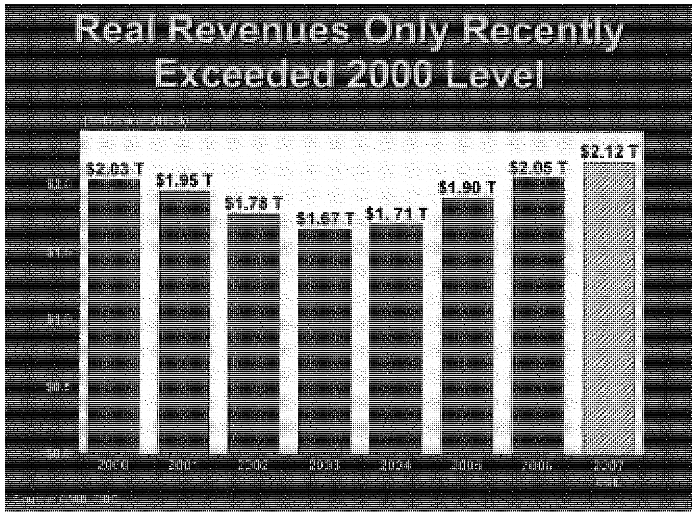
Chairman CONRAD. The hearing will come to order.

We apologize for being somewhat tardy in beginning this hearing. We try to start these hearings on time every morning and I think we have succeeded every morning. But we wanted to have an informal discussion with the Secretary and see if we could not have a constructive discussion about things in a way forward.

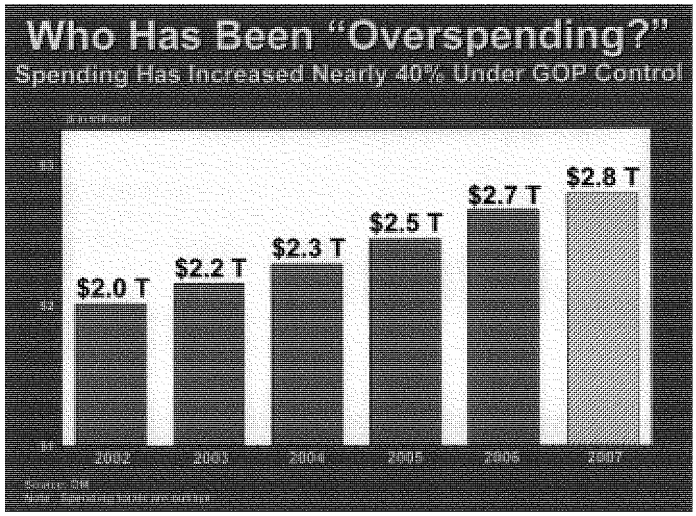
I want to welcome the Secretary to the committee and say that we have enjoyed our discussions with him since he has come into this office. We see him as a very constructive player and want to acknowledge that publicly.

Let me just begin by talking about the revenue. The Secretary of Treasury, of course, as the preeminent responsibility in the administration on the revenue side of the equation. Let me just talk about it.

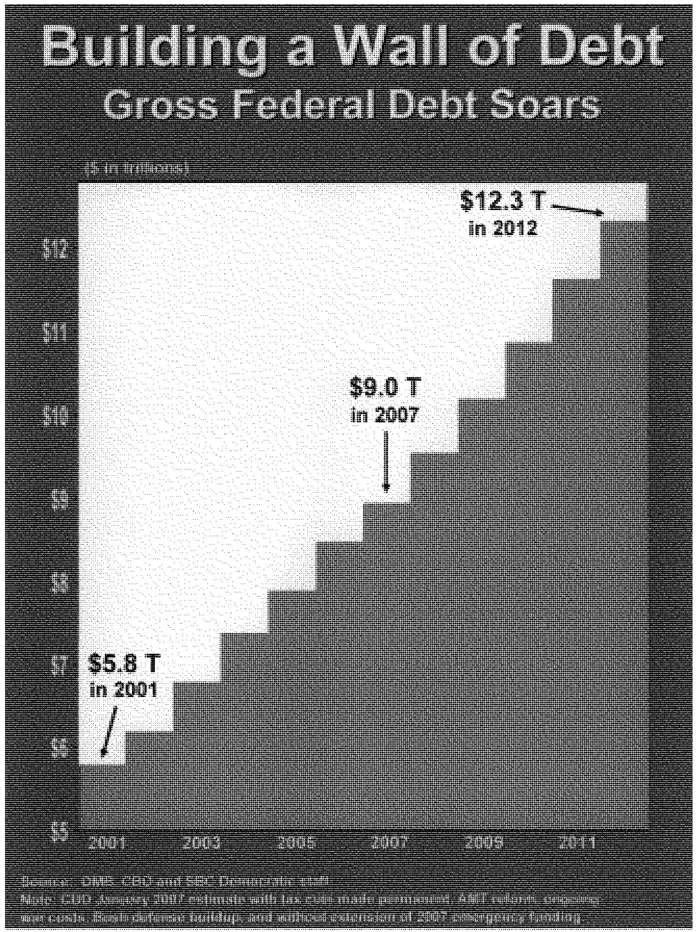
You saw this the other day in the Finance Committee. It is true that we have had good revenue growth the last several years. But if one looks back on a comparison basis to 2000, and these are real revenues adjusted for inflation, you see it took until 2006 to get back to the revenue we had in 2000.



On the other hand, spending has gone up by 40 percent and the result of this combination, revenue down and spending up, has been to explode the deficit and the debt.

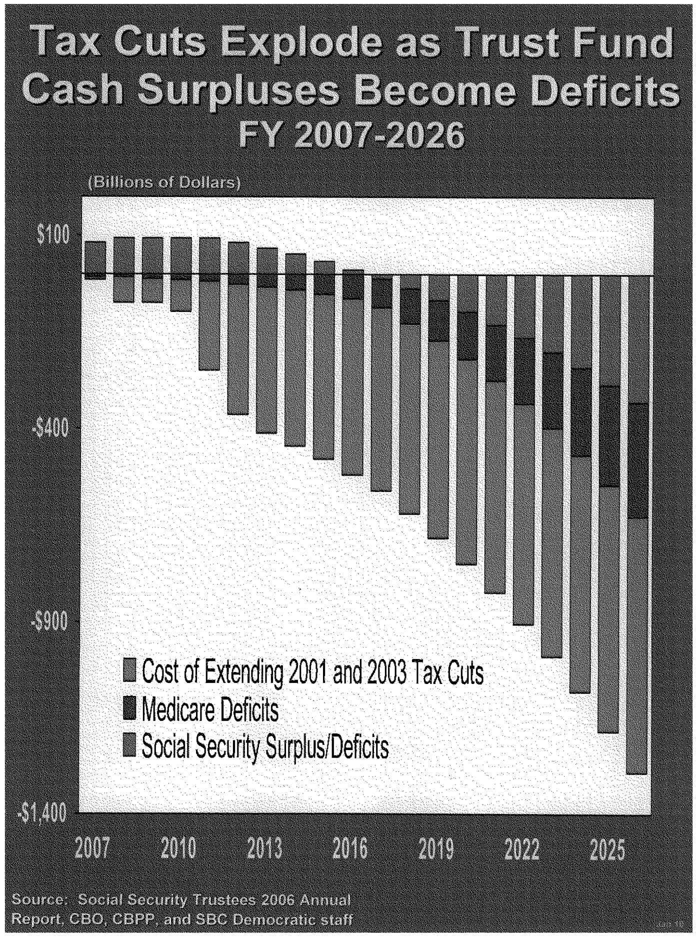


We can see we have had an increase of the debt from $5.8 trillion at the end of the first year of this Administration to $9 trillion projected at the end of this year, which is exactly what you would expect. If you cannot pay your bills in the first place, and you cut revenue and raise spending, the imbalances grow.



One of the results of this is we have become increasingly dependent on what I call the kindness of strangers. We are increasingly borrowing this money from abroad. As this chart shows, it took 42 presidents 224 years to run up $1 trillion dollars of United States debt held abroad. That is now more than doubled in the last 6 years.

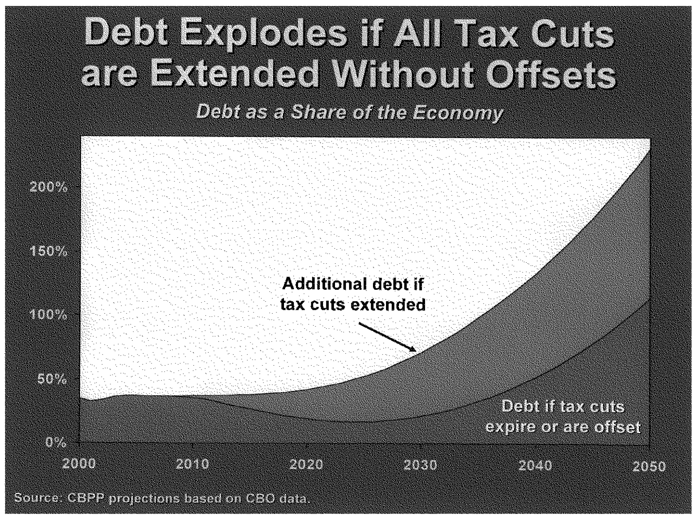
This chart shows if you make the President's tax cuts permanent at the very time the trust funds go cash negative, the cost of the tax cuts explode, and it takes is right over a cliff. That is, if we extend these tax cuts without paying for them.



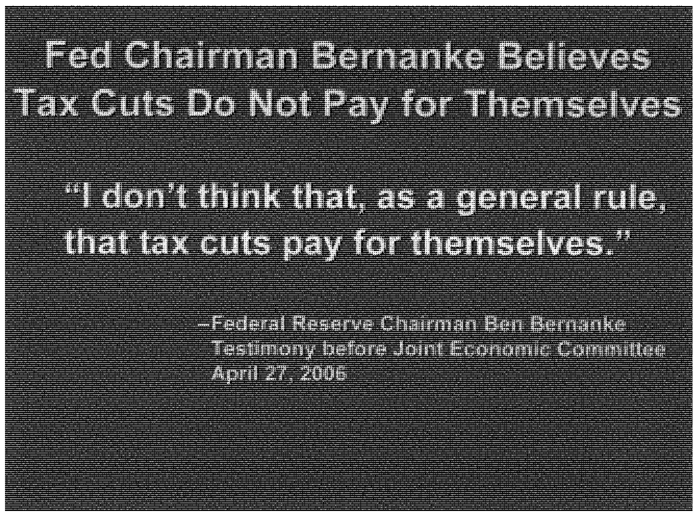
You know, I like tax cuts as much as anyone and I have been a great beneficiary of these tax cuts, personally. But we face a situation with this demographic change that—we face a demographic change that is going to require us to do a lot of things we would prefer not doing. That means we have to have savings out of the entitlements. I believe, as part of a package, it means we are also going to have to find more revenue.

Let me be swift to say I think the first place we ought to look for revenue is not a tax increase. The first place we ought to look is this burgeoning tax gap, $350 billion a year.

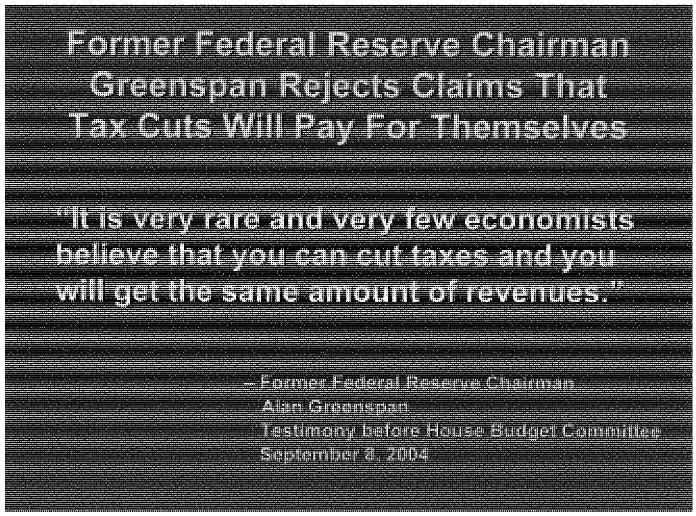
This chart shows what happens if the tax cuts are extended without paying for them, without offsetting them, and the debt in the out-years explodes. Every single witness before this committee has acknowledged we have a very serious long-term problem and an unsustainable budget condition.



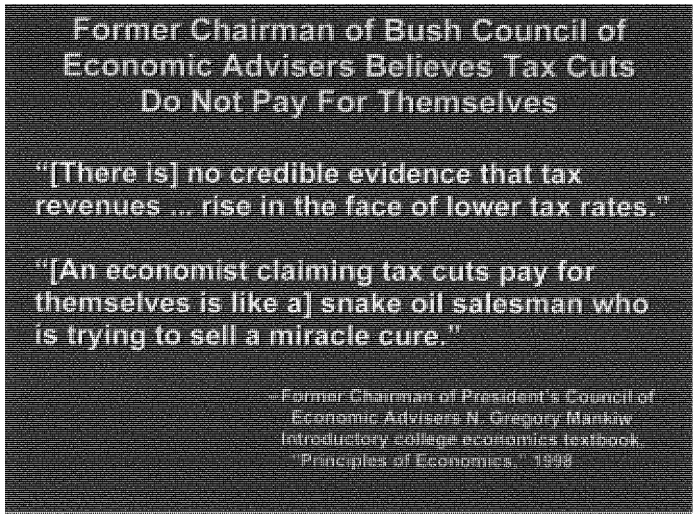
This is the question of whether tax cuts pay for themselves. We have heard a lot of discussion from people that suggest that tax cuts pay for themselves, perhaps more than pay for themselves. This is the Chairman of the Federal Reserve saying I do not think that, as a general rule, tax cuts pay for themselves.



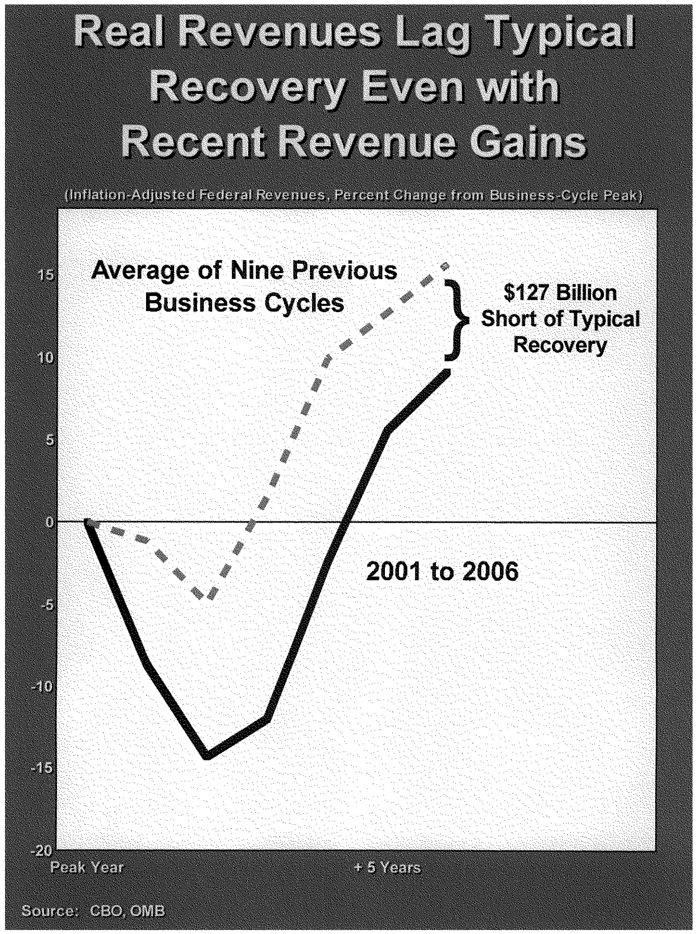
And he is not alone in that judgment. This is former Chairman Alan Greenspan who said it is very rare and very few economists believe that you can cut taxes and you will get the same amount of revenues.



The former Chairman of President Bush's Council of Economic Advisers, Dr. Mankiw, wrote in his introductory college economics textbook there is no credible evidence that tax revenues rise in the face of lower tax rates. And economists claiming tax cuts pay for themselves is like a snake oil salesman who is trying to sell a miracle cure.



The fact is that even with the recent revenue improvement, real revenues are still lagging behind what they would be in a typical recovery. We have looked at the nine previous recoveries, major recoveries, since World War II, and we see in this recovery revenue still lagging behind the average of the nine previous recoveries, and by a substantial margin.



We see the same thing when it comes to jobs. We do not need to put up that.

As I noted earlier, what is really missing from this budget and from our discussions is a commitment to tackle these long-term fiscal imbalances. Let me just say, we have had the head of the General Accounting Office tell us we are in an unsustainable situation. We have had the Chairman of the Federal Reserve. We have had the head of the CBO. We have had a parade of witnesses here, from every philosophical stripe, tell us we have a serious long-term problem. That is really what I would like to focus on today, to see if we cannot find a method or a means to get us to a discussion about how we begin to resolve these long-term imbalances.

I believe, I know you do, Mr. Secretary, that it would be entirely in the country's interest if we were able to find a way to take steps, the beginning steps, of reducing these long-term fiscal imbalances.

Again, I thank you for being here and I now ask Senator Gregg for his remarks.

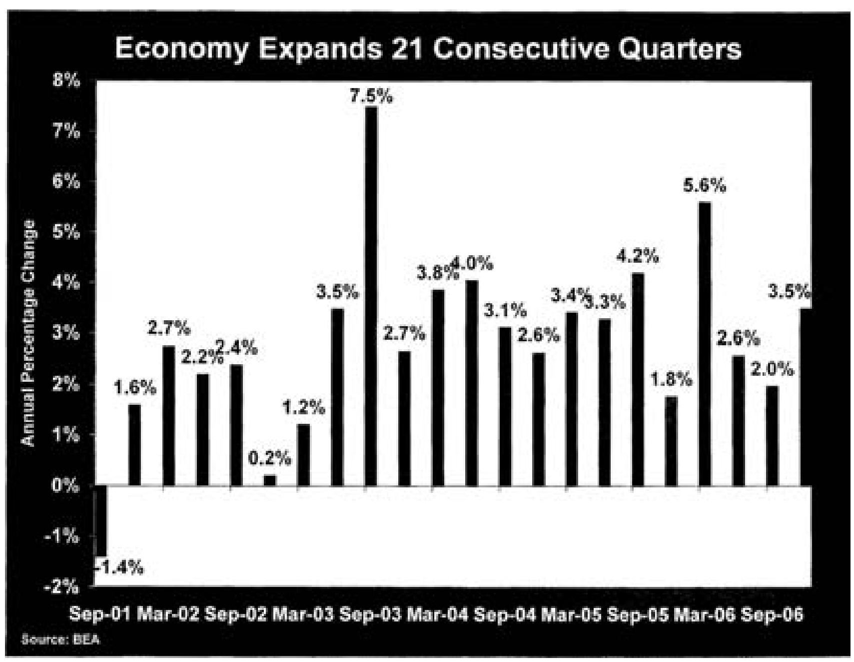
OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Thank you, Mr. Chairman, and I also wish to welcome the Secretary of the Treasury, who has already, in his short tenure, been a very constructive force, in my opinion, for trying to move forward the debate and discussion as to how we resolve our long-term fiscal issues which, as the Chairman has appropriately and effectively alluded to, are the gravamen of the problems for our Nation as we move into the future relative to policies that do not involve terrorism.

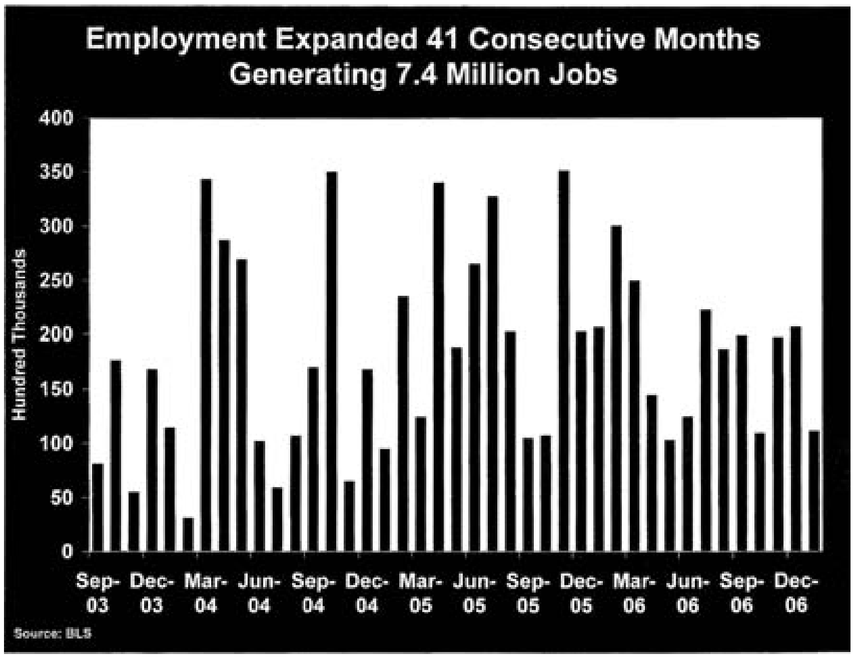
If you are looking for the biggest problem we have, it is the fact that we are going to pass on to our children a Government they cannot afford because it will simply be far too expensive to support the entitlement programs for the baby boom generation.

But I also think that there has not been enough focus on how well things are doing right now in many places and in many ways.

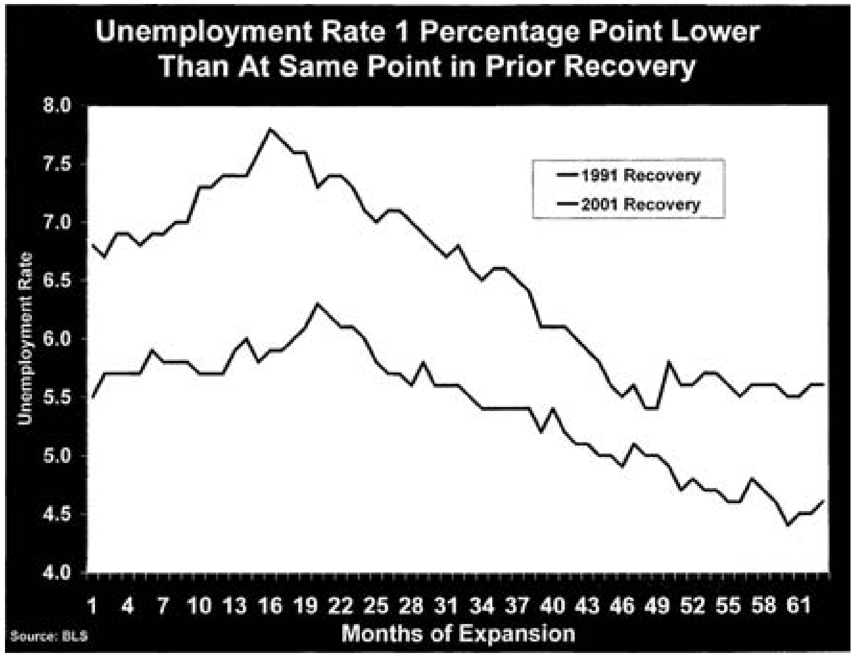
We have now had 21 straight quarters of economic recovery in this country. That is good news. These are significant growth numbers, and they are continuing.



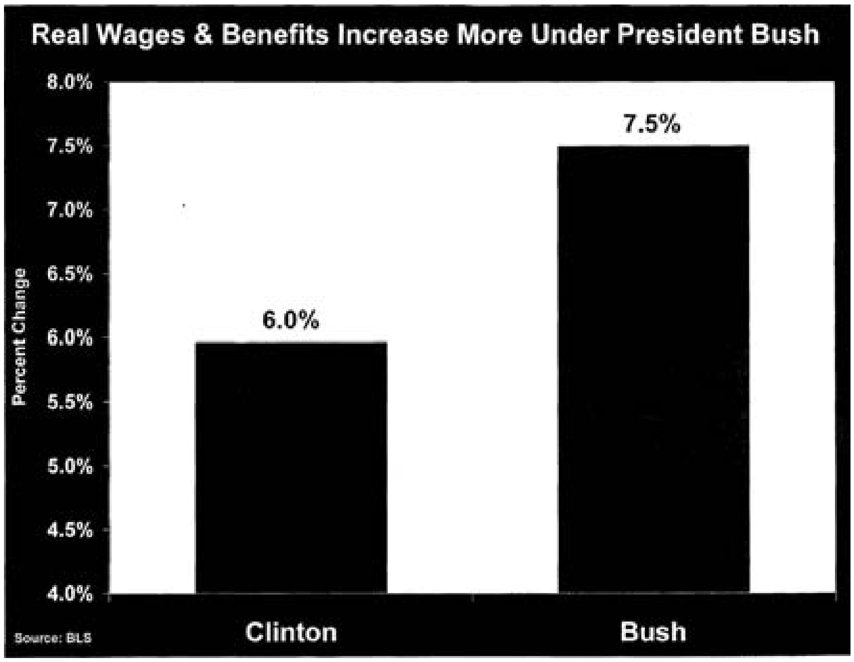
As the result of this recovery, employment has expanded for 41 straight months and we have added over 7 million jobs. That is a lot of people who have a much better lifestyle because they have a job that is, in most cases, a very good job and they are generating income.



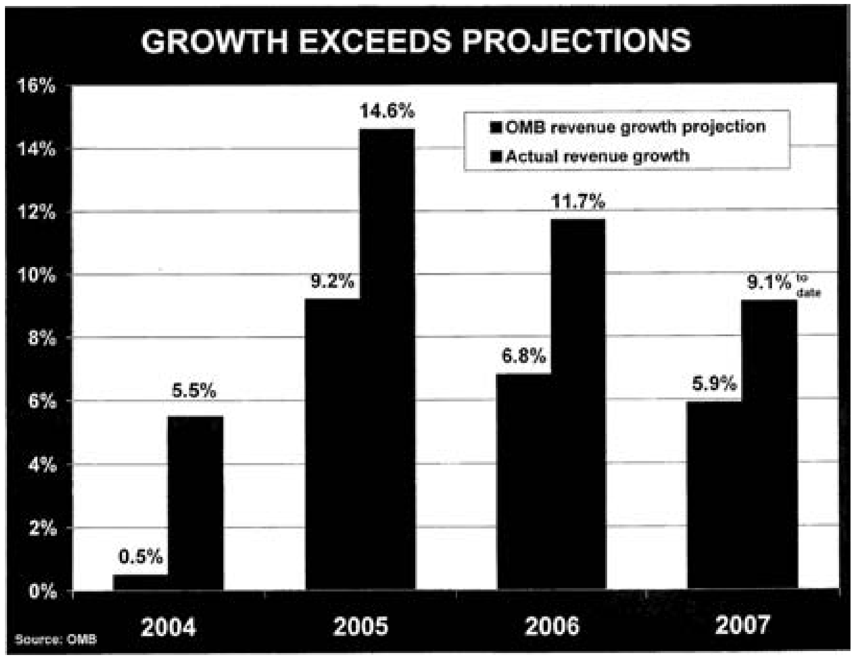
We have seen that the unemployment rate as a percentage is lower now than it has been in almost all of the prior major recoveries. So we are actually getting a larger amount of employment and we are getting a very strong recovery in this economy.

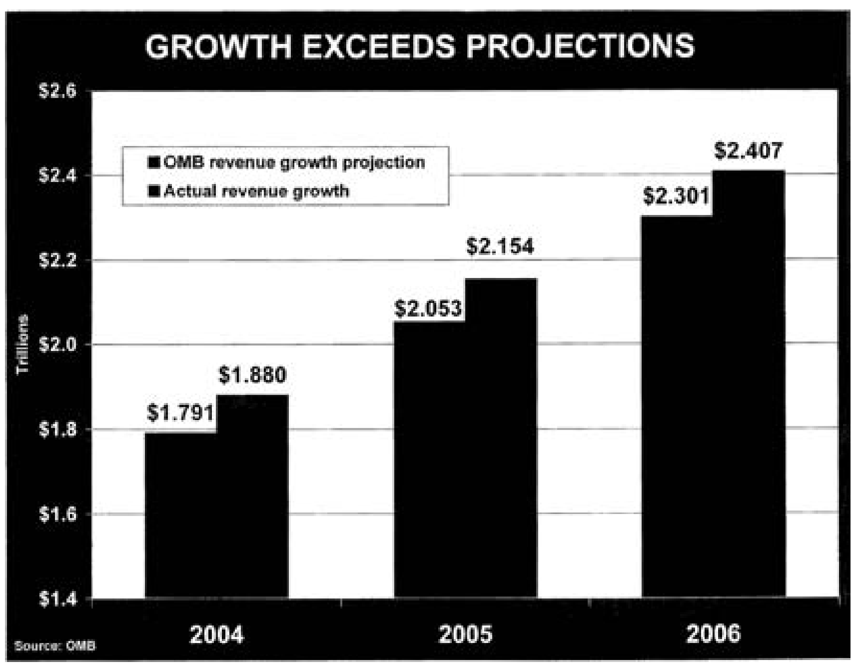


Real wages are up over the Clinton years. That is a very important statistic. We are hearing a lot about wage gap and we are hearing a lot about the middle class being squeezed. But the fact that we have had an expansion now for over 5 years and an employment increase for over 41 months and that those jobs are real wage benefits to working Americans, that shows that—that is good. That is what you want. You do not want the opposite, which is a negative situation.



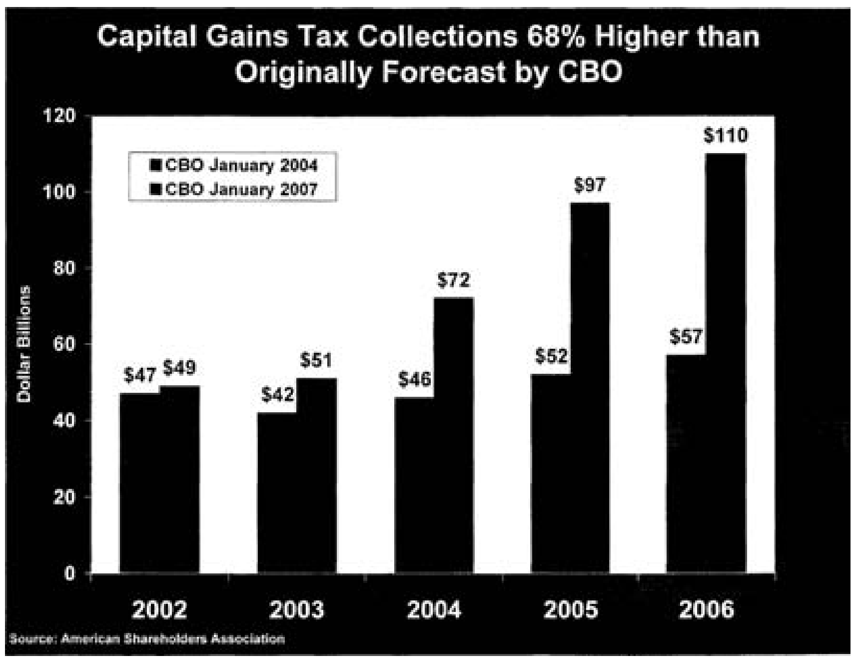
The growth in revenues has exceeded projections now in the last 4 years. The fact is, revenues have not only exceeded projections, they have essentially blown through the projections from CBO and OMB during the last 4 years. And we have seen, in the last 3 years, the three largest years of increase in revenue growth in the history of our country. That is very significant as a reflection of the growth of the economy, of course, and more people having jobs. And again, this is another chart that reflects the fact that growth is exceeding the projected growth for the last 3 years.





The Chairman says that cutting taxes does not generate more revenue. Well, we cut the capital gains rate and we generated a heck of a lot of revenue. It is just common sense.

It may be that economists tell you that cutting rates does not generate more revenue. But common sense tells you that when you cut the capital gains rate, you are going to generate some significant revenue because people who have locked up assets that they are not willing to sell because they do not want to pay that high tax rate, will start to sell those assets. And the ancillary effect, the unintended consequence effect, is that that revenue, once it is freed up, is then reinvested in much more productive capital activity, much more productive things. As a result you generate more economic activity, which creates more jobs, which is the bottom line we are aiming for, more jobs and a better economy.

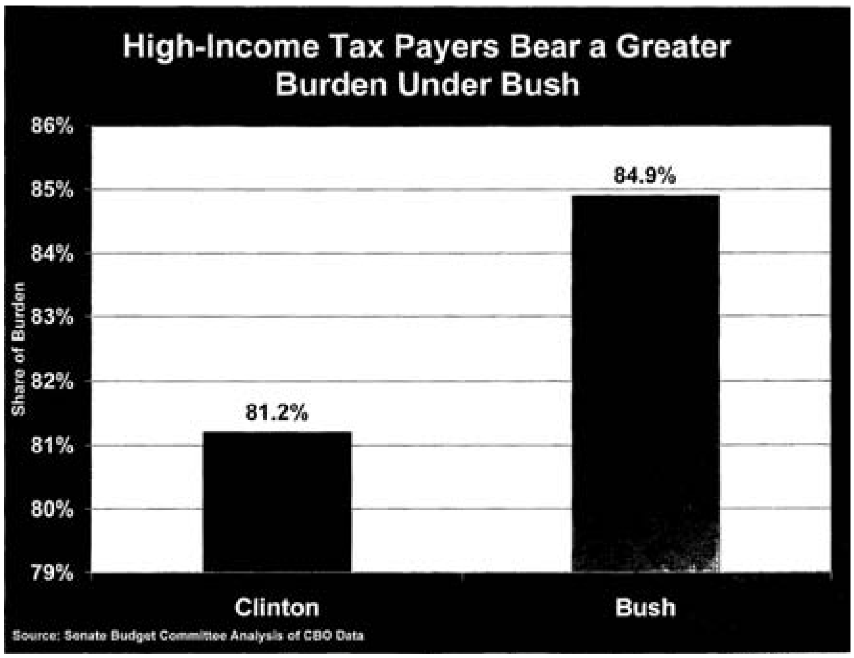


There is another point that should be made. The tax cuts which the President put in place generated this economic recovery which has gone on now for over 5 years, which has created over 7 million jobs, which has generate huge revenues to the Federal Treasury. Those revenues, by the way, today exceed the national averages. Traditionally, we get 18.2 percent of gross national product as Federal revenues. Now we are up to almost 18.4 percent of gross national product as revenues.

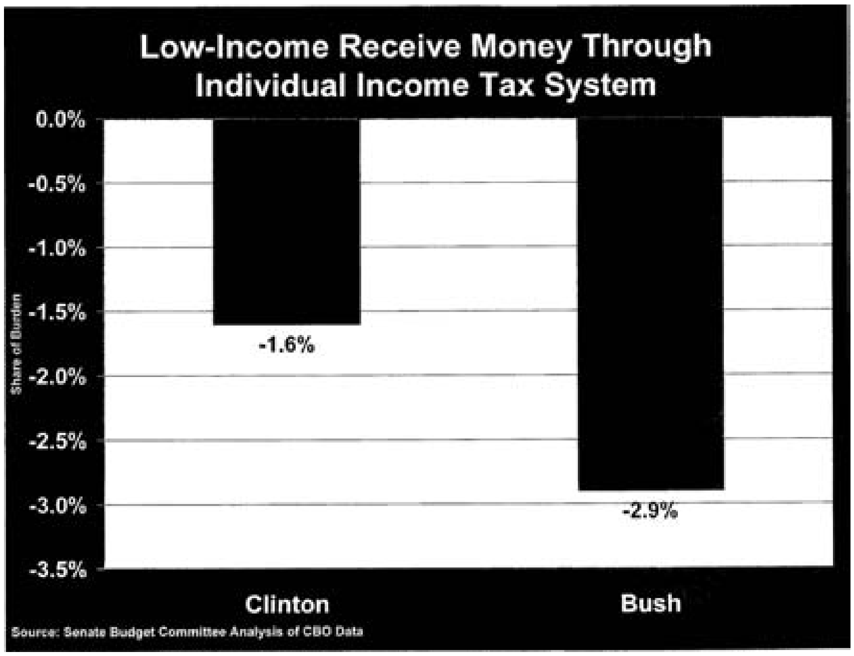
By cutting the rates and putting a fair tax law into place, we've created an environment where people are willing to pay their taxes and go out and take risks, be entrepreneurs, create jobs and, as a result of doing that, create more revenues for the Federal Government. That created a better revenue stream for the Federal Government.

At the same time, the President's tax cuts have actually created a more progressive tax system, which is never talked about, regrettably, by folks on the other side of the aisle. They are always talking about how high income people are always getting a better tax benefit under this Administration.

Well in fact, high income people are paying a higher share of the income tax burden in America today, than they paid in the Clinton years. 85 percent of the tax burden today is being paid by the top 20 percent of wage earners, of people with high income. Whereas under the Clinton years those 20 percent of high income individuals only paid 81 percent of the income taxes. So we have the higher income people paying more in taxes as a percentage of what we collect.



And I think the next chart shows that the low-income individuals in this country, who do not pay any income taxes who receive money back through the Earned Income Tax Credit, are actually receiving twice as much back today as they received during the Clinton years.



So what we have is a tax law which is significantly more progressive, where the high income individuals are paying more of the tax burden, and low income individuals are getting more benefit from the tax law than during the Clinton years.

And at the same time, we are generating dramatically more revenues than we historically have generated, and especially in the last 3 years we are generating significant revenues.

The practical effect of that is the deficit is going down. It is going down not because we are spending less money, but because we are generating more revenues. We have an expanding economy. We are creating more jobs. And that is all good news.

I think we ought to talk about it a little bit, so that is why I took these few minutes to talk about it.

I appreciate the Secretary of Treasury being here.

Chairman CONRAD. Thank you, Senator Gregg.

Again, welcome, Secretary Paulson. Please proceed with your testimony. As you can see, we have an amicable committee here, but we do not always agree.

STATEMENT OF HON. HENRY M. PAULSON, JR., SECRETARY, DEPARTMENT OF TREASURY

Secretary PAULSON. Chairman Conrad, Senator Gregg, thank you very, very much.

I am going to make a brief statement for the record and then we will be ready to take your questions.

As you know, I am very pleased to be here today to provide an overview of the President's budget for fiscal year 2008.

As the Secretary of Treasury, my top priority is keeping America's economy strong for our workers, our families, and our businesses. And the President's budget supports that goal.

We start from a position of strength. Our economy appears to be transitioning from a period of above-trend growth to a sustained level of about 3 percent growth. More than 7.4 million jobs have been created since August of 2003.

Our unemployment rate is low, at 4.6 percent, and over the last 12 months real wages have increased at 1.7 percent. Economic growth is finding its way into workers' paychecks as a result of low inflation. That means family budgets are going further.

Strong economic growth also benefits the Government's fiscal position. In the first quarter of fiscal year 2007, budget receipts totaled $574 billion, an increase of 8 percent over the same period in fiscal year 2006. As a result of increased revenue over the last 2 years, we have brought the Federal budget deficit down to 1.8 percent of GDP.

The President has submitted a budget that reflects our strong economy and our Nation's priorities: continued job creation and wage growth, vigorous prosecution of the War on Terror, increased access to affordable health insurance, improved energy security, a strong fiscal position from which we can address the long-term challenges such as sustaining Social Security and Medicare for future generations.

This budget supports a strong economy by maintaining fiscal discipline. It maintains our current tax policy, which has helped our economy rebound from recession to its current robust health. With a steadily growing economy, tax revenues combined with fiscal discipline should bring the Federal budget into balance in 5 years.

In fact, we are submitting a budget that includes a surplus in 2012, which is achievable if we keep our economy growing. While no one has a crystal ball, our economic assumptions are close to the consensus of professional forecasters.

The President's budget addresses important domestic priorities. Health care is high on this list. Under current law, the tax subsidy for health insurance purchased through employers will average more than $300 billion a year over the next 10 years. For that large expenditure we get a system in which rising costs are a burden to families and businesses, and in which millions of people have no insurance at all.

The President's proposal would make health care more affordable and more accessible. It would give all taxpayers who buy health insurance, whether on their own or through their employer, and no matter what the cost of the plan, the same standard deduction for health insurance: $15,000 for a family or $7,500 for an individual.

The President's proposal would help hold down health care costs by removing the current tax bias that encourages overspending. Costs would become clearer, giving patients more power to make informed choices about their health care spending. The proposal would also jumpstart the individual insurance market, so consumers have more choices than are available today. Health care would become more consumer driven, more affordable, and more accessible for millions of Americans.

Energy security is another concern of the American people, and it is a priority addressed in the President's budget. President Bush has put forward an ambitious goal of reducing America's projected gasoline consumption by 20 percent over the next 10 years. We can achieve this goal by dramatically increasing the supply and use of alternative fuels, and improving fuel efficiency by reforming and increasing CAFE standards. The expanded fuel standards will provide entrepreneurs and investors a guaranteed demand for alternative fuels, which will accelerate private investment and technological development.

Reforming CAFE standards will allow us to increase the fuel economy of our automobiles as fast as technology allows. With a more diverse fuel supply and better fuel efficiency, we can make our economy less vulnerable to supply disruptions and confront climate change through technologies that reduce carbon dioxide emissions.

Finally, the President's budget, by emphasizing fiscal discipline and economic growth, lays the right foundation for dealing with entitlement reform, a challenge we all have a responsibility to address.

Strengthening Social Security and Medicare is the most important step we can take to ensure retirement security for our children and grandchildren, the long-term stability of the Federal budget, and the continued growth of the American economy.

I look forward to sitting down with Democrats and Republicans without preconditions and finding common ground in these critical issues.

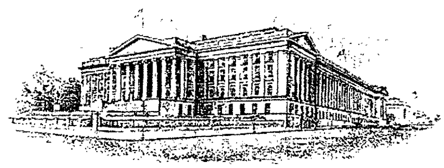
Mr. Chairman, the President's budget priorities, a strong economy, national security, fiscal discipline, health care, energy innovation, and laying the groundwork for entitlement reform, are the right priorities for America and for the workers, businesses, and investors who drive our economy.

I am confident that working together we will keep our economy strong and chart a course for maintaining our global leadership in the years ahead.

Thank you for the opportunity to discuss this today, and I now welcome your questions.

Thank you.

[The prepared statement of Secretary Paulson follows:]



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EST) February 8, 2007
CONTACT Brookly McLaughlin, (202) 622-2920

TESTIMONY OF TREASURY SECRETARY HENRY M. PAULSON BEFORE THE SENATE BUDGET COMMITTEE ON THE PRESIDENT'S FISCAL YEAR 2008 BUDGET

Chairman Conrad, Senator Gregg, Members of the Committee:

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I am confident that, working together, we will keep our economy strong and chart a course for maintaining our global economic leadership in the years ahead.

Thank you for the opportunity to discuss this today – and I now welcome your questions.

Chairman CONRAD. Thank you, Mr. Secretary. Thank you, again, for your testimony and thank you for your service.

Let me go to one of your last statements, a discussion about going to the table without preconditions with respect to the challenges our country faces because, in large part, of this demographics tsunami that is coming at us of the baby boom generation.

When you say without preconditions, what does that mean to you?

Secretary PAULSON. Let me step back and say it was very clear in your charts that entitlement reform is the biggest issue. We had a good conversation yesterday at the House Budget Committee, and Chairman Spratt there showed some numbers. They disagreed with our assumptions, with our budget, and he said that we are wrong and that the deficit will be $145 billion based upon the numbers he is looking at in 2012.

I said that I very respectfully think that we can work toward, I believe, our numbers, and we can reduce and eliminate the deficit and have a surplus in 2012.

But the differences we are talking about are very small, $145 billion in 2012 is 0.8 percent of our GDP. And so what we have staring us in our face, and the reason we all care about this, is because of the long-term problems.

So what it means to me is that we are not going to solve this unless we have a bipartisan solution. And so what I am trying to do, at the President's direction, is to take the politics out of this and to say, without prejudging outcomes, without trying to negotiate this in the public arena, let's bring people together and say any idea. Anything you want to talk about, I want to talk about. And we will take any idea seriously.

There is no doubt that the President feels the way he does about tax relief. You saw his ideas on Social Security reform over the last couple of years. He does not believe you need to increase taxes. He thinks personal accounts are a good idea. And other people feel very strongly on the other side. So the President has said let's start over. Let's have a clean sheet of paper. Let's come to the table without preconditions.

So to me that is really what it means. It means that people on both sides will present their ideas, and we will not do it in a public forum. We will do it in a way in which we can make progress and take some of the political rhetoric out of this.

Chairman CONRAD. I thank you for that. I think that is a very constructive statement. And I am absolutely persuaded that you come to this with sincerity and a conviction that we have an opportunity here, and really a responsibility, to try to make progress. So I welcome that statement.

I want to go back to the question, because it really is very central to this debate, whether or not tax cuts pay for themselves or generate more revenue than they lose.

Last summer the Treasury Department, and this was before you were there, the Treasury Department under your predecessor did a dynamic analysis of tax cuts. And here is what they concluded. Treasury's dynamic analysis of the President's tax relief indicates that making the tax relief permanent can be expected to increase the level of annual output by about 0.7 percent.

The Congressional Research Service then translated that into what it means in comparison to the cost of the tax reductions, and here is what the Congressional Research Service told us last summer. The base case estimates in the Treasury's dynamic analysis suggest that the induced effect on output, were the tax cuts to be extended, would lead to a revenue offset of 7 percent of the initial cost.

Now that is your own department's analysis. This was before you were in the department. I want to be fair, this was under the previous Secretary of the Treasury.

Let me go to the Washington Post article. Greg Mankiw, who I cited, who was a top official, was Chairman of the President's Council of Economic Advisers, has tested the notion that tax cuts pay for themselves. He is a very distinct economist, as you know, again Chairman of this President's Council of Economic Advisers.

He looked to the extent to which tax cuts stimulate extra growth and the extent to which the growth generates extra revenue. Here is his conclusion: even over the long-term, once you have allowed all of the extra growth to feed through into extra revenue, cuts in capital taxes—which Senator Gregg was referring to—juice the economy enough to recoup half of the lost revenue. This is the tax type that has the biggest payoff. Senator Gregg is right about that, taxes on capital have the biggest payoff.

They do enough to recoup half of the lost revenue. Cuts in income taxes deliver a boost that recoups 17 percent of the lost revenue.

So $100 billion cut in taxes on capital widens the budget deficit by $50 billion. A $100 billion cut in income tax widens the budget deficit by $83 billion. That is Dr. Mankiw's conclusion.

We have our own Congressional Budget Office that did an analysis on what the effect of a 10 percent reduction in personal taxes and how much of that would be paid for by the cut. On the most of optimistic assumption it could muster, the CBO found the tax cuts would stimulate enough economic growth to replace 22 percent of the lost revenue in the first 5 years and 32 percent in the second five. On pessimistic assumptions, the growth effects of tax cuts did nothing to offset revenue loss.

In fact, in the most optimistic of these analyses, done by your own department, done by Dr. Mankiw, the former Chairman of Economic Advisers under President Bush, done by our own Congressional Budget Office, in no case did the tax cuts come close to paying for themselves, nowhere close. And these are under the most optimistic assumptions, the assumptions being that the tax cuts were financed by cuts in other Government spending.

As you know, these tax cuts are not financed by cuts in other Government spending. These tax cuts are financed by deficit spending. When you finance tax cuts with deficit spending, the conclusion of all of these analyses is that there is virtually no offset.

Now I would just ask you, do you agree with your department's analysis on tax cuts not paying for themselves, not coming close to paying for themselves?

Secretary PAULSON. Mr. Chairman, as I said when I answered the same question at the Senate Finance Committee and at my confirmation hearings, I have never argued that tax cuts pay for themselves entirely. In terms of getting into the details about how much, this is something I do not think we really can do with precision.

What I have said, which I really believe, is that I have seen it in the real world. I was in Wall Street when the bubble burst, the stock market bubble, when we went into a recession after 9/11. And I watched behavior change with these tax cuts. I have no doubt they created a foundation for growth. I do believe it is very hard for economists or anyone to evaluate behavioral changes.

One thing that I have used before as an example is to look at the upper rate. But that is really tax relief for a big part of small business, the Schedule C filers. You probably have known small businessmen. I have known small businessman all my life.

Chairman CONRAD. I come from a family of small businessmen.

Secretary PAULSON. What do you do if you are a small businessman? Oftentimes, every penny you save, you plow back into your business.

So there is no doubt in my mind that we have an economy that is robust and that revenues are coming in well above the estimate.

One of the things I am trying to study and I am spending time trying to figure out is actually why we have been so wrong in estimating, underestimating the revenues.

Chairman CONRAD. Let me ask you this. My time has really passed. Your department has concluded, with a dynamic analysis, a dynamic analysis, that the base estimate of your department is that the tax cuts only pay for 7 percent of their cost.

Do you dispute that analysis? Or do you agree with it? Or do you want to back and review it?

Secretary PAULSON. I have to tell you, I have not read that analysis carefully or looked at it carefully.

Chairman CONRAD. I would just ask you if you would do that and get back to us and let us know do you agree with it, do you disagree with it, and the reasons.

Secretary PAULSON. I will do it, but I would speculate that I will get back to you and say it is a very inexact science. And I will probably come back and say I would never try to influence the way the great people at Treasury—very, very independent economists—are doing their analysis.

So I will understand what they have, but to me that is not critical to the discussion we are having today. But I will get back to you.

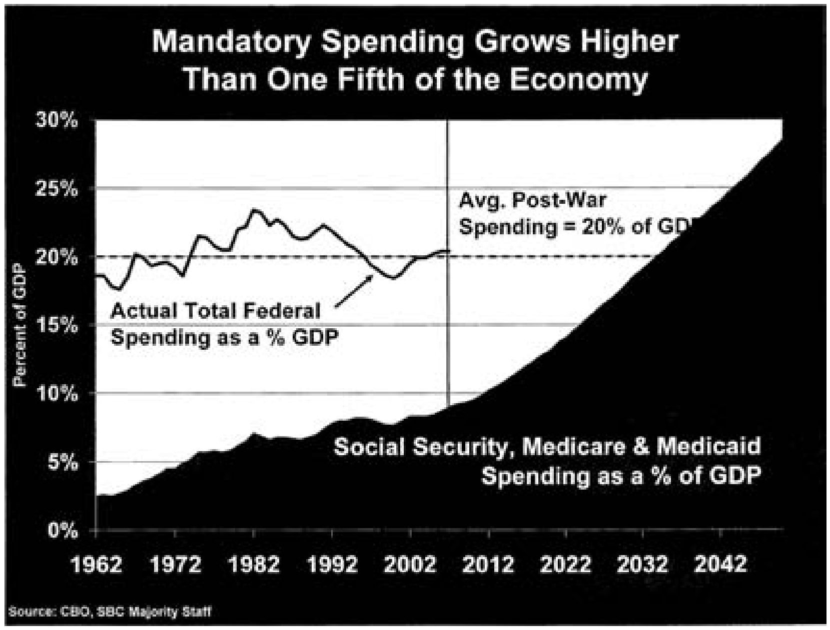
Chairman CONRAD. Let me just say, I think it is critical in the sense that we look to your department for professional guidance. And we need to have the best guidance we can on this issue, among many others.

Senator GREGG.

Senator GREGG. Thank you, Mr. Chairman.

Of course, the issue is not whether the tax cuts pay for themselves. That is a straw dog. The issue is whether or not you have a tax law which generates enough revenue to support the Government or whether you grow the Government to the point where you simply will never be able to catch up with the taxes because you will make it impossible for people to bear the burden of the taxes that they would be hit with.

Let me show you a chart which reflects this fact. If you just take the three major entitlement accounts, Medicare, Social Security and Medicaid, you will see that they presently are around 5 percent or 6 percent of gross domestic product. But as the baby boomer generation retires, those accounts, as a percentage of the gross domestic product, grow radically. And by the year 2030, 2028, they absorb 20 percent of gross domestic product. The historical mean of what the Federal Government has spent is 20 percent of gross domestic product.



And that just continues to grow. So historically, the amount of taxes which the Federal Government has taken, is about 18.2 percent, which would be a little bit below the 20 percent of spending. But the practical implications of this chart is that you cannot tax your way out of this problem unless you are willing to put a tax burden on the American worker which is so high that the younger people in this country will end up paying so much in taxes that their quality of life will drop dramatically and the productivity of the economy will probably drop dramatically.

But certainly the younger people, my children and your children and our children's children, will not be able to send their kids to college, will not be able to buy the house they want, because they will be paying taxes to support this burden of Government.

So the issue is not whether tax cuts pay for themselves. The issue is whether or not the tax law that you have in place generates enough revenue to support the Government, and at what level will the Government be set? How much is the Government going to take out of the economy?

Now today we know that the present law, the President's tax proposals are supporting an income to the Government that exceeds what the Government has historically received. We are getting about 18.4 percent of gross domestic product in revenue, as versus the traditional revenue of about 18.2 percent.

So the tax cuts are working. They are generating a fair amount of revenue to the Federal Government. The problem is we are just spending a lot more than we are taking in. And we are going to spend even more in the future than we are taking in because of the retirement of the baby boomer generation.

So my question to you, Mr. Secretary, is independent of whether or not the tax cuts pay for themselves, is the tax burden that we have on the American people today a fair one? Or are they undertaxed?

Secretary PAULSON. I would say that I totally agree with your numbers. You look at the last 40 years, the last 50 years, the average has been 18.1 percent. And it is now 18.4 percent. You can look at that and then look at the fact that revenues are coming in, frankly, faster than any of us had expected, any of us on either side of the aisle had expected.

So I agree with your point.

Senator GREGG. The point that the Chairman has made that I do agree with—and we actually agree on quite a few things, and we very much agree on this point, and we consider it to be the essence of the problem—is that chart, which I just held up, shows that we are facing an explosion in costs for this Government that will be inordinate and historic and unsustainable. And everybody that has testified before us says that.

The question becomes you have to match revenues to expenditures in order to have a strong Government or come fairly close to that. In the out-years what percentage of the economy, and I have asked this of everybody who has testified, what percentage of the economy should the Federal Government take? Today it is taking 20 percent. Should it take 22 percent, 23 percent, 24 percent? Is there a number at which, when the Federal Government starts to take that amount of the economy, the economy goes into a nonproductive spiral because the burden of the Government has become so high?

Secretary PAULSON. Senator, I do not know the answer to that question, and I will tell you why. It is because as I have looked at it and looked at the problem, the problem is so big in a number of years that I do not think we need to answer that question with great precision. We do not have to go too far out to know that we are going to be hitting a situation where there is either going to be no money left for any other discretionary spending, our taxes are going to be at the level where they stifle all of us, or we are going to be really hurting our children and our grandchildren in terms of their retirement security.

I know I am singing to the choir because I see both you and the Chairman nodding your head. As I look at this, I tell people I have no doubt that this country will solve this problem, this entitlement problem, at some time. The frustrating thing for all of us is the longer we wait, the more costly it will be, and the more difficult it will be. And the longer we wait, we are going to have to answer these questions you have asked with a lot more precision. I think we are not going to like the answers because there is clearly a level at which the taxes will really burden this economy and make us noncompetitive.

There is clearly a level at which we are not going to be able to have the amount of discretionary spending we need to take care of our other needs.

Senator GREGG. And the collateral point to that is that you obviously are going to have to do the majority of this on the spending side.

Secretary PAULSON. Right, yes.

Senator GREGG. Thank you.

Chairman CONRAD. The ranking member may be surprised by this. I happen to agree with him. We cannot tax increase our way to a solution of this problem.

I also believe, and the point I was trying to make, is you cannot tax cut your way to a solution to this problem. It is going to take a balanced, comprehensive approach. And I think most of it is going to have to be on the spending side of the equation, given the magnitude of the baby boom generation.

Senator SANDERS.

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

Mr. Secretary, let me take this discussion in a little different direction. Very often when we talk about the economy, we talk about the economy in a general sense. But the American people are not a general, they are real human beings who have real concerns.

What is your judgment on the fact that the United States has the most unequal distribution of wealth and income of any major country on earth? That we have, to our shame, by far the highest rate of childhood poverty of any industrialized nation, depending on the studies that you look at, between 18 percent and 20 percent? Should we be proud as Americans?

We hear people telling us how wonderful this economy is doing. Mr. Secretary, how wonderful is the economy doing when we have by far the highest rate of childhood poverty in the industrialized world, with some 20 percent of our children living in poverty? Can you tell me how that reflects on our economy?

Secretary PAULSON. Senator, first of all, in terms of your numbers, I have looked a good bit at income distribution. And what I have seen is a trend that I have seen in most parts of the world that has been going on for 30 years. In some countries it was more pernicious. And so when you look at what I saw going on in Mexico—

Senator SANDERS. But we are not Mexico, sir.

Secretary PAULSON [continuing]. And China.

Senator SANDERS. We are not China.

I do not have a lot of time and I know that the Chairman will use his gavel.

Secretary PAULSON. Let me answer your question.

Senator SANDERS. In the United States, the wealthiest 1 percent own more wealth than the bottom 90 percent. The gap between the rich and the poor is growing wider, and we have the highest rate of child—forget China—in the industrialized world. What do you think about that?

Secretary PAULSON. I would say that what is going on right now is something that is happening all over the world. It has been happening here for 30 years. But what I think about it is that we are doing a lot, and we need to continue to do a lot.

Senator SANDERS. What are we doing? I do not have a lot of time.

Secretary PAULSON. OK, I will tell you—

Senator SANDERS. Let me ask you a question and please give me an answer. I do not have an endless amount of time.

When we talk about childhood policy, one of the issues related to that is the disastrous situation with regard to child care and Head Start in this country. We underfund Head Start, huge numbers of families cannot get it. The budget that the President has just presented us would cut by $300,000, between 2006 and 2010, millions of children from getting child care.

Do you think that that is an effective way of dealing with childhood poverty?

Secretary PAULSON. To get back to your question of what are we doing about it, I will answer that very directly. What you have seen under this President is 5 million taxpayers taken off the Federal income tax rolls. So 5 million additional people do not pay taxes.

Senator SANDERS. But what else have we seen? You use the 5 million—

Secretary PAULSON. And you have seen—

Senator SANDERS. Sir, unless the Chairman wants to give me some additional time.

But we have also seen, more importantly, since President Bush has been in office, 5 million more Americans slipping into poverty. Can you tell me, is that a good thing, 5 million more Americans are poor today than before President Bush took office.

Secretary PAULSON. I would say to you, Senator, that I have focused a lot on income distribution. It is something I am very focused on. I think the No. 1 thing we can do for all Americans, rich or poor, and particularly for people at the low end and in the middle, is keep an economy growing, keep creating new jobs. They will all do better—

Senator SANDERS. But sir, that is not the record. Since President Bush has been in office, almost all of the new income created has gone to the very wealthiest people and 5 million more Americans have slipped into poverty. Millions of people have lost good paying jobs and are working jobs for lower wages. How is that good news?

Secretary PAULSON. I would say to you that I do not agree with the numbers.

Senator SANDERS. You do not agree that 5 million Americans have slipped into poverty?

Secretary PAULSON. I have not heard that number. And I would just tell you, when you talk about the millions of Americans that are losing good jobs, I will say there are good jobs being created all of the time. And the thing I look at most carefully is what is happening to the average worker.

And I am very pleased that over the last year we have seen real increases in wages.

Senator SANDERS. In the last year.

Secretary PAULSON. In the last year.

Senator SANDERS. That is good, but President Bush has been in office for 6 years.

Secretary PAULSON. I would say that what we have seen in other recoveries, and it was very similar in the 1990's, is that if you can keep productivity high, keep creating new jobs, productivity will find its way into real wage increases. And we are making progress.

Senator SANDERS. I think, sir, you have a tough sell. What you are trying to do is convince the middle-class and working-class of this country that things are going well. They are not buying it, because they know that they cannot afford increasingly health care. And since President Bush has been in office 6 million Americans have lost their health insurance.

They know that more and more people are becoming poor. We see some young people here. Middle-class families know that they are finding it increasingly difficult to send their kids to college. We have lost 3 million good paying manufacturing jobs. And while, in fact, we have seen in recent years a growth in new jobs, many of those jobs are paying lower wages and lower benefits than the jobs, in fact, that we are losing.

People are seeing folks on Wall Street ending up with $50 million bonuses while they are losing their pensions. They are losing their health care, when they retired, the health care benefits that they were promised.

So what you are seeing is a Nation in which the people on top are doing very, very well. The middle-class, in fact, is shrinking, not because of President Bush. This is a long-term trend. But right now a two-income family has less disposable income that a one-income family did 30 years ago.

I am not blaming this all on President Bush. It has a lot to do with trade policy. It has a lot to do with the lack of unionization in this country.

We will continue this discussion another time. Thank you very much, sir.

Secretary PAULSON. Actually, I thank you for your comments. I would like to talk with you some more, particularly about trade policy.

Senator SANDERS. I would love to do it.

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. Thank you.

First, let me say to you, Secretary Paulson, I got a chance to meet you since you have been appointed and I have not had a formal opportunity. But the private one was very exciting for me because I thought that where you came from and what you worried about, based upon what you have written, that you are the right person for this job.

What a tough job we all have, and it is not all yours. But I would suggest a couple of things that I think I know from having served here for a long time.

One, there is just no way we are going to solve the deficit problem by continuing to attack almost singularly the appropriated accounts every year. It has now reached the point where we cannot produce a budget, in my opinion, of the President's level in that account, that big account, that can pass and be implemented throughout the year. I will start with that. Whomever that helps, I am not saying where I am voting. I am just saying each year that one is getting where it can less and less do the job.

I hope you will think that true because I think the conclusion is absolutely inevitable.

But that does not mean that our problem is still not that we must cut growth in Government. That is what we must do, instead of worrying so much about increasing taxes. We have to find a way to solve the problem of ever spiraling costs of Medicare, Social Security, and Medicaid, although Medicare is a different breed of program.

And I wanted to suggest to you that there is a bill called Senate Bill 355. I put that in with Senator Feinstein, and I would hope you would look at it.

The reason I put it in is because I have given up on Congress, even with leader president, I have given up that we will modify Medicare or Social Security in any significant way. And both are doable. But I do not think Congress will do it.

Therefore, this is for a bipartisan commission to recommend how to do it. And I truly believe if you could read it and give us your views, I think it can do the job. It has the right input, the right people, the right rules, and reports its results to the right people, who must act.

And I think that is a lot better than wringing our hands, that we must squeeze the appropriated accounts another time for $3 billion or $4 billion or $5 billion, when the debt is so much bigger and we know it—the deficit, excuse me, and we know it.

Having said that, just do you agree theoretically that what we have to do is what I said? Not my bill but—

Secretary PAULSON. Senator, I do agree philosophically that the biggest issues we face are the long-term spending—Medicare and Medicaid—and other entitlements—Social Security.

Senator DOMENICI. I think it is good if you become a little bit more of an expert on them. You are a quick learn. Because you cannot just deal what the theoretical Treasury problems and help us solve our problems.

Let me tell you another one that is quick, but everybody is trying to come up with an idea on how to fix our global warming, that is some carbon containment so it does not get out there as we burn it.

I submit to you that everybody is looking for a law that will do it which will put all kinds of impacts on business and it will become just another master of bureaucracy on trying to collect carbon tax or whatever it is. Now just think with me for a minute.

The real problem is that we are not getting enough in investment or solution to new technology that takes the carbon out of the coal. Instead of trying to solve that, we are trying to change the law and burden business one way or another.

Question to you: what if we introduced a bill that said this bill has, as its purpose, the financing for the next decade of those who wish to invest in new technology that will direct itself at converting coal and getting the coal sequestered permanently in the process.

Would that not be just the same as passing one of these burdensome bills, if not better?

Secretary PAULSON. Senator, let me say it is a complicated topic. But I will tell you that technology has been very important to this president. And as I have looked at it and studied the issue, there is no doubt that coal is the backbone of power generation around the world.

In our strategic economic dialog with China, one of the things we talk about a lot is clean coal technology, the FutureGen project. So

I do believe that in any solution we come up with, one important part of it should be new technology. Clean coal has to be a very big part of it. So I agree with you there.

Thank you.

Senator DOMENICI. Mr. Secretary, it seems like the Federal Government is going to have to push the technology. And I submit to you that a very big program of loan guarantees or the like for this kind of work on a 10-year basis will find the breakthroughs sooner than just insisting that we have a new law that takes away things from business.

Secretary PAULSON. I do agree there is clearly a role for Government. And right now you will see we have a very rigorous approach to this, and we are funding, at the Federal level, clean coal technology. There is a lot of work being done on this.

I think it is actually quite encouraging, some of the progress.

Senator DOMENICI. Thank you, sir. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Speaking about economists, as the Chairman did earlier, I can put 25 economists in a room and ask them and give them exactly the same circumstances. And guess how many answers we will get? Twenty-five different answers.

Chairman CONRAD. Fifty.

Senator BUNNING. Fifty, that may be true, too.

Secretary PAULSON. That is right, on the one hand, and then on the other. Unless they are all one-armed economists.

Senator BUNNING. You are taking my time now, and I have not asked a question.

[Laughter.]

Senator BUNNING. Under the Bush Administration, we have increased earned income tax credit dramatically and we have doubled the child tax credit in the last 5 years. And there are 40 million senior citizens now getting prescription drugs that did not get them before the Bush Administration took office, just as a matter of fact, under prescription Medicare Part D.

Let me just ask you a couple of questions. Thank you for coming, first of all.

I was pleased that the President's budget calls for a repeal of the sunset of the marginal tax rate relief. I am very concerned about some proposals I have heard from Members of Congress to increase the marginal rates and the impact such proposals could have on our small businessmen and women.

Given the enormous number of jobs created by small business in this country, what effect could such a tax increase have on the strong job growth and overall economic strength that we have enjoyed in recent years?

Secretary PAULSON. I would just say to you that I would clearly not recommend a tax increase. I think that is why it is important to make this tax relief permanent. I think one of the positives, which you have pointed out Senator, which I do not think is generally understood, is when you look at that top bracket it applies to the individual Schedule C filers, which are—

Senator BUNNING. And S–Corps, too.

Secretary PAULSON. Yes, and S–Corps, which are small businesses.

Senator BUNNING. Yes, which are all small businesses.

Secretary PAULSON. This is a marvelous thing, this American economy, just a marvelous thing. We all sit here and think we are doing things in Washington that are responsible for everything, but it is the American businessman, the American worker. And I do believe we need to look for ways to help them. I take your point, and I agree with it.

Senator BUNNING. Since our economy is extremely strong, and there are people that are debating whether it is or not, and our unemployment rate is very low at 4.6 percent, which historically over the 1960's, 1970's, 1980's, and 1990's and into the 2000's, is at a historic low for a period of long-term.

Economic growth has averaged over 3 percent growth for more than 20 straight quarters. Yet some Chicken Littles are trying to convince the American public that the sky is falling in, or else they are trying to ignore the fact that record performance of the economy was engineered by sound economic policies.

Do you believe that the policies put in place by the President and the Congress over the past 6 years have contributed to this remarkable growth of our economy? What would be the economic impact of reversing the President's tax relief or allowing the tax relief to expire?

Secretary PAULSON. I would say, Senator, I do believe, as I said earlier, that these economic policies—the tax relief—has been very important, provided a real foundation for growth, helped investor confidence, changed behavior, and made a very big difference.

I think all of us should feel fortunate that this expansion is continuing. It is stronger now than I believed it would be. So I would not—

Senator BUNNING. I have one more question.

Secretary PAULSON. I am sorry. I would not recommend that we raise taxes.

Senator BUNNING. OK.

We talked about entitlements and the reduction in the rate of growth that has been put into the President's budget. It is less than 1 percent in Medicare and less than 1 percent in Social Security or Medicaid and on down.

But when we project that reduction 75 years out, it saves \$8 trillion long-term. I would like your comment on that.

Secretary PAULSON. I think you have it. And so you look at Medicare, and what we are doing is putting some ideas on the table to reduce the trajectory of growth over 10 years from 7.4 percent to 6.7 percent. You are right. You are dealing with such big numbers, just changing the rate of growth a small amount makes a big difference.

I can see you have studied these things very carefully, and I appreciate it.

Senator BUNNING. Thank you very much.

Chairman CONRAD. I heard you say, in response to Senator Bunning, that you would not recommend a tax increase. Is that correct?

Secretary PAULSON. Correct.

Chairman CONRAD. I assume that you are saying that in reference to the extension of the 2001 and 2003 tax cuts that otherwise expire?

Secretary PAULSON. Yes.

Chairman CONRAD. But does not the President's budget have, in just the same way, a tax increase on the alternative minimum tax, since those provisions, under the President's budget, sunset after 1 year? The provisions to prevent a massive tax increase.

And so in the President's budget, and this is from the Tax Policy Center at Treasury, you have almost $500 billion of tax increase as you have defined it here. Is that not the case?

Secretary PAULSON. Yes, Mr. Chairman, let me address that. I think we are all agreed that we do not want the alternative minimum tax to go into effect without extending the current patch. As I have said before, it would be cruel and unintended, and it would be a real surprise to hit the middle class.

And so what we have done in the President's budget is put forward a budget where there is an additional year of relief. That is to give us time to work together to solve this problem.

Chairman CONRAD. But the President's budget would not balance without the revenue that flows from what you have defined here as a tax increase.

Secretary PAULSON. I would say that what we have seen now, I think for the last 6 years, is that this 1-year patch is what Congress has done. What we thought made most sense was to go ahead with that 1 year of additional relief, and then work together. And I am hopeful that we will work together and come up with a solution.

Chairman CONRAD. I appreciate that, but the reality is as you have defined tax increase, this is a tax increase. And it is a large one. It is $500 billion of revenue that, if you did not have in this budget, this budget would not balance. Is that not the case?

Secretary PAULSON. There is no doubt that if the alternative minimum tax went into effect without extending the patch, it would be a cruel tax increase. It would be an unintended one.

Chairman CONRAD. Because my time is fleeting, as well, let me ask you this if I could. Are there ways that we could increase revenue without increasing tax rates?

Secretary PAULSON. I would say obviously you can, by reducing spending.

Chairman CONRAD. No, I'm talking about on the revenue side now.

Secretary PAULSON. On the revenue side I do believe it is very interesting. When we looked at our budget, and when I did the analysis and compared it with our projections, with the CBO projections, and others, it is just clear to me how dependent all of this is on a growing economy and keeping an economy strong. And that is really where the biggest sensitivity is.

Chairman CONRAD. Let me try to help you and suggest that—

Secretary PAULSON. So I would say to you that I think the biggest way we increase revenue without increasing tax rates is through economic growth.

Chairman CONRAD. Without question. And what other ways?

What I am trying to lead you to is the tax gap. As I see it, and help me understand how you see it, the Revenue Service has told us before this committee that they now believe the tax gap, the difference between what is owed and what is paid is now $350 billion a year. And while the vast majority of us pay what we owe, I believe the vast majority of companies do as well, we have some number of individuals and companies who are not. Is that not a way of increasing revenue without a tax increase?

Secretary PAULSON. How much time do I have to respond to that?

Chairman CONRAD. Go ahead.

Secretary PAULSON. I am going to try to be brief, but this is one that I have thought about a lot because when I arrived here Chairman Baucus told me how serious he was about this.

I looked at the numbers, and the numbers are not as good as we would like. The last real serious estimating efforts were in 2001. Under my direction we are going to be taking a much more careful look this year.

But the estimates, the number I would use was $290 billion, which was the net tax gap. I began looking at this the way all of us look at it, which is to say that it is outrageous to any of us who pay taxes that we all are paying more taxes because some people are free riding and are not paying anything. For some of them, it is done through intent, and for others, it may be because they inadvertently do not pay the taxes.

But as I looked at this, what I found, and we are working hard on this, is that the vast majority of the tax gap come from individual taxpayers, and it is the result of underreporting. You can look at it. There are some non-filers, and there is some underpayment. But the biggest piece is underreporting.

As you delve into that and you look at that, the majority of the underreporting comes from business income. So it is Schedule C, and a lot of it is small business and farmers who are underreporting.

And then you say OK, so how do you get at that? The conventional wisdom was if we make the tax code simpler this will help shrink the tax gap. That is right, it will help shrink it. But frankly, to get at the big numbers and the biggest portion of it, we would have to make it more complicated because it means more reporting.

As I have looked at it, there are a number of things if we wanted to get it, we would have to do, which I think, frankly, none of us will want to do. That is because they would be the kinds of policies that will be very onerous. It would be the sorts of things like a lot of reporting, 1099s. I have used the example that if you hire a plumber, you would have to fill out the 1099, give him a coypy and send a copy to the IRS. Or on the family farm where the wife is selling eggs, going through the same procedure.

Another way to get at it, and I spent a bunch of time with our people on this, would be to have electronic receipts or credit card receipts for everything. Moving in that direction, moving away from the cash economy and having all of those receipts go to the IRS.

Or big withholding. I remember when Dan Rostenkowski had withholding on dividends and interest. There was big objection to that, and Congress repealed it. Well, you could have withholding on pension payments, on interest, on dividends.

And so as I have looked at it, what I have to say to you is that I would love to come up with ways to finance through the tax gap. We are going to be working hard on this. But it is not a pot of gold. I am just convinced that this is not a pot of gold that is going to finance the AMT or other things.

I wish I could tell you otherwise. We have 16 legislative proposals that have to do largely with reporting. I am urging Congress to pass those. And I understand why there may be some resistance, because even those—

Chairman CONRAD. How much will that raise?

Secretary PAULSON. That will raise about $30 billion over 10 years. And even there, some of them are going to have a delayed effect. One of them, for instance, involves the securities industry and would require brokers to report the basis of securities. And there will be a lag effect because that proposal would go into effect, if it is passed, in 2009 and would apply to securities that are bought after 2009 and then are sold thereafter.

But this is not going to be easy. We have what we think is an aggressive IRS budget. We would like to get that funded. I appreciate your support over the years in always funding the IRS in any of our efforts there, supporting the budget, and helping pass our legislative proposals.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you.

What you are saying is that most of the tax avoidance is a cash economy that is very hard to track without a lot of paper and a lot of bureaucracy.

Secretary PAULSON. Boy, I wish I could have said it that quickly and clearly. I am going to take lessons from you, Senator.

Senator GREGG. One of the things we have been talking about in this committee, and I think appropriately so, is the amount of ownership which we have of our debt by foreign holders and the fact that our debt, as a percentage of gross national product, has gone up. And it will go up radically if we have these numbers facing us.

And you are, unquestionably, the best expert we have ever had in the Government on the issue of debt since Mr. Rubin was serving, I suspect. You are probably even better than Mr. Rubin.

Secretary PAULSON. I would not say that.

Senator GREGG. Anyway, your expertise is unquestioned.

I would just like to get out your thumbnail thoughts on having foreign ownership of debt? Is it worse than having American ownership of debt, our own debt? And at what point does foreign ownership of debt become a risk because they lose their confidence in us? Is that a potential that we should fear? And if it is, what would lead to that?

Secretary PAULSON. Thank you, Senator. Again, I have looked at this carefully.

First of all, we all should know why we have the foreign ownership of debt. We have a current account trade deficit. We also have an economy that is growing, and we really want to keep our economy growing. We are not saving, in this country, and we have very high savings rate in other countries. China has a 50-percent savings rate, for instance. And so it is very important that we have foreign ownership of debt.

And as I have looked at it, there is great diversity in the holdings—in foreign holdings, individuals, governments—great diversity.

I will give you a couple of numbers that are fresh in my mind because, as I testified before Senator Dodd's committee on China, I was asked these questions. We have roughly $4.4 billion of treasuries outstanding and held by the public. When you look at that, we have about $346 billion of them held by Chinese. That is 8 percent of the total.

Now some of those are held by individuals and some by the Government. We do not break that down publicly. But we have $500 billion of our Treasury securities traded every day. So that is less than 1 day's trading volume.

Japan is the biggest holder when you look at individuals and the government. That is $650 billion roughly, a little bit more than a day's trading volume.

So as I look at this, there are many other things I am more concerned about than this. The key to all of this is to keep with policies that generate confidence in our economy, so that all holders of Treasuries, whether they are overseas or in the United States, buy Treasuries because they think it gives them the best risk-adjusted rate of return and because they have confidence in our economy.

The way I think about this is we need to work on these imbalances. It is going to take a number of years to work our way out of these imbalances. I am encouraged by the fact that with regard to the trade deficit, we have now had four quarters in a row where our exports are growing faster than our imports. This last year, our exports to China grew at 33 percent, our imports at 19 percent. Our exports added 1 percent to our GDP in the fourth quarter.

So we are making progress but it is going to take a while as we work through these imbalances. And I do not believe the foreign holding of debt is a symptom. It is a natural outcome of the trade imbalance. Given the diversity of holdings, the liquidity of Treasuries, I am not particularly concerned about that problem.

Senator GREGG. I appreciate that explanation.

If I could just make one comment—I really do, those were very substantive thoughts.

But on the issue of how you do not have to increase rates to generate revenue, you mentioned expanding the economy obviously as the best. And the Chairman has mentioned collect taxes that are owed.

I would like to put the third item on the table, which is that you go back to the 1986 Tax Reform Act which is that you clean the code of deductions and you actually cut rates and generate more revenue.

Secretary PAULSON. Absolutely, simplification. You are absolutely right.

Senator GREGG. Thank you.

Chairman CONRAD. If I could just follow for one moment and then Senator Whitehouse is next.

If I could ask you any proposals you would have with respect to what Senator Gregg just raised, that is tax reform proposals, base broadening proposals that Treasury has worked on, that would be of interest to the committee.

Secretary PAULSON. Thank you very much, Mr. Chairman.

In light of the fact that there has been very major tax reform in 2001 and 2003, and given how important this entitlements issue is, our major priority had been coming up with incremental tax reform, and a big effort in terms of this incremental reform is with a standard deduction for health care.

And I am quite interested and am doing work on tax reform. We will continue to do work on tax reform as it relates to competitiveness and base broadening, looking at the corporate sector, and what it takes in this century to be competitive.

And so you will see work as we go through the course of this year.

Chairman CONRAD. That would be very interesting and very helpful.

Secretary PAULSON. Thank you.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Mr. Chairman. I see that my clock has been restored to working order so I am no longer operating in a time-free zone down here.

Mr. Secretary, first of all welcome, pleasure to have you here.

I would like to touch base following a little bit on what Senator Sanders said. We see an expanding income gap between the rich and the poor, a dramatic one that goes back and is unmatched since robber baron days. It strikes me that it is not attributable to any particular fault collectively on the part of the middle class. Indeed, working folks seem to be producing at a higher level production than ever, or an increasing one anyway. It does not appear to be the result of any particular new level of achievement on the part of the wealthy and more fortunate members of our society.

It appears, rather, to be the product in significant measure of secular economic forces around the world, of the flattening economy, of new levels of competition for labor and so forth.

Secretary PAULSON. Technology.

Senator WHITEHOUSE. And technology. And it is having a really pronounced societal affect that is beginning, I think. I guess the question is where does that go?

I see huge risk of climate change from global warming creating enormous stresses. And the obvious solutions to it would appear to me to be price driven and likely to result in increases in fossil fuel, utility, heating oil, gas costs, all things that, as a portion of the household budget, are a larger portion for lower and middle-income families.

So as we solve that critical national and international problem, again, a second hit on these families on top of the secular drift that is taking place right now. On top of that I see tax, trade and budget policies of this country that accelerate that drift even further, supporting wealthy and corporate interests and cutting what are, in many cases, vital supports for working families.

And the three seem, to me, to be adding up to a kind of a perfect storm. And I am interested in your thoughts on just how far you think we can go, as an American society, in terms of this increasing and potentially limitless discrepancy between the trajectory of wealthy families and the trajectory of working-class families before it creates social, political, economic, and really moral issues that change the face America presents to the world and change the way we look at each other?

And if you think it is serious, where in this budget do we find anything that helps?

Secretary PAULSON. Senator, thank you for that comment. It is very consistent with Senator Sanders' comment.

Senator WHITEHOUSE. It is a New England thing.

Secretary PAULSON. And I think, this is something that many of us are thinking about right now—the growing dispersion of income And what is causing it.

As I learned long ago, it is very interesting to know there is a problem. It is much more valuable to ask what do you do about it?

But I do want to say one thing in terms of the cause. I really do believe that a very big part of what is going on is technology. Part of it is integration into the global economy.

The reason I mentioned that is because I do not hear anybody say, and I am sure you would not say, let us turn back technological growth, let us put that back.

Senator WHITEHOUSE. I think, actually sir, on a net basis it has been hugely positive. The problem is that some people are losers and some people are winners in that net forward and that itself becomes a problem at some point.

Secretary PAULSON. I agree.

And the reason I say that is because I feel the same way about trade. Your statement about technology I would make about trade, also. We have been net gainers. The reason I would say that is I think if we move toward protectionist policies, it would be very similar to try to pull back technological advancement, and it would hurt the very people we are trying to help.

Now having said that, I think a bit—

Senator WHITEHOUSE. That still leaves the people who, because of the trade changes and because of the technological changes, are getting hurt. How do you help them?

Secretary PAULSON. I think there has to be a big focus on what we do. And I like the way you are approaching it, not in terms of class warfare, but how do we help the people on the bottom? How do we help the average worker?

I am just going to say what I said to Senator Sanders. First of all, I am not saying this alone is sufficient. But keeping this economy growing and keeping new jobs growing is essential, because whatever the issues, they are going to be greater if we do not have that, if we do not have the position of economic strength.

The more you study it, the more you see it really comes down, to a large extent, to education and training. It also involves thinking about how in this century we think just more precisely about it, practically about what we do there, and coming up with programs that also are more effective at dealing with the job losses and dislocations.

Because no matter what we are doing just generally, there is no doubt that trade does cost jobs. It does not cost net jobs, it adds jobs. But to those who lose their jobs—

Senator WHITEHOUSE. That doesn't help the family who just lost their job.

Secretary PAULSON. To those that lose their jobs, we need to ask how do we deal with those specific situations because society overall is benefiting, and there is a higher standard of living because of it.

So I think you really are pressing on the issue that we are all going to have to deal with together over the next 10 years. I am sorry.

Senator WHITEHOUSE. No, no. I just wanted to get permission from the Chairman, because I have gone over my time, just to make one additional point.

Secretary PAULSON. I went over for you. I am sorry.

Senator WHITEHOUSE. No, no, that is fine.

Chairman CONRAD. Let me just stop you, if I can, at that point. Let me just say kind of my rule of thumb here is we have 5 minute rounds, but I try to give each Senator about a 2-minute additional bump. That is how I have operated here, as you can probably tell.

But we will have additional round. It really is Senator Sanders' turn, if we could.

Senator SANDERS. Senator Whitehouse, I will pick up where you left off. So you did not lose time, we are raising the same issues here.

It seems to me, Mr. Chairman and Mr. Secretary, that sometimes here in D.C. we get a little bit isolated from reality. You made a statement a moment ago, this is a paraphrase that "this is a marvelous thing, this American economy" roughly speaking.

Now I have to say I think that if millions of people all over America were listening to your statement, people who had fallen into poverty, people who today are working longer hours for lower wages than used to be the case, maybe one of the 6 million Americans who have lost their health insurance, maybe one of the millions of workers who were promised a pension but that pension was reneged, taken away from them, maybe a mother who is desperately seeking affordable child care in her community as she goes out to work 40 or 50 hours a week to earn enough money to take care of her family.

Do you know what she would say? Sir, what world are you living in? And that maybe, maybe we are hanging around with folks in the country clubs and CEOs of large corporations for whom this economy is a very, very marvelous thing, to use your word. But it is not a marvelous thing for the middle class. We have to get our act together.

The fact is, and I think all of the evidence suggests this, that the middle class is shrinking. When you and I were growing up the expectation was that one breadwinner in a family, usually the men back in those days, could work 40 hours a week and earn enough money to provide for the family. One person, 40 hours a week.

How many people, Mr. Chairman, do we know in America today, middle-class families, where one person is working 40 hours a week? Quite the contrary. The vast majority of middle-class families, husband and wife are working. And it is not uncommon for them to be working more than 40 hours a week.

In fact, in this marvelous economy that you are talking about, you may or may not know that in the United States our people work the longest hours than in any other industrialized country. I believe a few years we surpassed the Japanese, who also work very long hours. How is this a marvelous economy?

Now, my question to you, and I am a little bit blunter than my good friend from Rhode Island. I look at what is going on having to do a lot with one word, and that is greed. Frankly, I do not believe that the Bush Administration is trying to help all of the people. I do not believe that at all. I think you guys work day and night to help the people on top. And I think you have turned your backs on middle-income people, working people, and low-income people.

Sir, the United States is the only nation in the industrialized world that does not have a national health care program. The only one of any major country. In your judgment, should health care be a right of all people, as is the case in every other major country on earth?

Secretary PAULSON. You know. I feel very strongly that we need to work toward a system where everyone has access to affordable health care. But to me that is not a nationalized program.

Senator SANDERS. Not nationalized. But every other country has said that, as a right of citizenship, people should have health care. We are the only one in the industrialized world that does not. And I am hearing you say that you do not think that that should be the case.

Let me ask you another question. We have heard a lot of discussion about Social Security. In my view, Medicare is a very serious problem. I do not think Social Security is. Right now Bill Gates and the wealthiest people in this country contribute into the Social Security system the same amount of money as somebody who makes $94,000 year, roughly speaking.

My understanding is that if you simply lift the cap and you said to the wealthiest people in this country, people who by and large their income has soared in recent years, if you lift that cap as we have done with Medicare and ask them to contribute proportionally into the system, we would not have a Social Security problem.

Now given the fact that the wealthiest people in this country have seen huge increases in their income in recent years, why should not they be asked to contribute more into the Social Security system so that we can solve that problem and make sure that Social Security is vibrant and strong for the next 75 years?

Secretary PAULSON. Senator, you could also do that by taking a progressive approach to benefits.

Senator SANDERS. Well, you could.

Secretary PAULSON. Of course you could.

Senator SANDERS. You could. But this, I think, would be the simpler way, if you want to keep Social Security as a universal system protecting all people. I frankly think that Bill Gates, not that he needs it, is entitled to Social Security, too. And once you start doing away with universality, you are going to eventually make it into a welfare program, which is not a good idea.

Secretary PAULSON. I did not suggest doing away with universality. I suggested progressivity.

Senator SANDERS. Should we ask, should we lift the cap and solve the Social Security problem by asking the wealthy to contribute more into the system?

Secretary PAULSON. That would not be my suggestion.

Senator SANDERS. Why? Don't you think it is fair that at a time when the wealthiest people have never had it so good, and the gap between the rich and the poor is growing wider, that simply lifting that cap can solve the problem?

Secretary PAULSON. I think you and I are not going to solve the situation right here at a public hearing. Maybe you will be one of those who comes to the table and that will be your idea.

Senator SANDERS. Let may go back to an issue that I feel very strongly about, that as the middle class declines and as you see husbands and wives out working, we see in the budget that the President submitted a program which would reduce the number of children receiving child care assistance by 300,000 at the same time as the budget provides $739 billion in tax breaks to households with incomes exceeding $1 million.

In addition, your budget asks veterans in this country to pay more for their health care.

Can you explain to me the morality of cutting back on child care, asking veterans to pay more for their health care at the same time as we sustain huge tax breaks for billionaires? What is the morality of that?

Secretary PAULSON. I see you have a point of view, and I would suggest that when Secretary Leavitt is here and is talking about the health care program, maybe he can go into the details of that with you.

Senator SANDERS. Just let me conclude, Mr. Chairman, and thank you for the extra time, we are not just talking about economics. We are talking about a moral perspective. We hear a lot about moral values. Let me be very clear. You do not give tax breaks to billionaires, ask veterans to pay more for their health cut and drive them off of health care, cut back on child care, cut back on Head Start.

To me those are not moral values.

Thank you, Mr. Chairman.

Secretary PAULSON. Can I just say one thing that I think you and I can agree on? When I said it is a marvelous economy, what I meant is this is an economy that makes it better for virtually everyone. Better than we would have if the economy, were a no growth or a slow growth economy. This is an economy that is a very strong economy in terms of jobs that are being created, inflation, et cetera.

I did not mean to suggest that there are not some people in this economy that we would all like to see do better. And so I am very aware of what is going on with income distribution, and I am very focused on the average worker and people at the bottom.

So I look forward to talking to you.

Senator SANDERS. I hope that we can continue this discussion. Thank you very much.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for your testimony.

I have one overarching question and then some specific questions. I read your testimony. But I have a problem in believing that we can tell the American people that we can afford $1.7 trillion in permanent tax cuts that will continue to benefit a disproportionate number of higher wealthy taxpayers, continue to fund the war at more than $8 billion a month with no real end in sight, ignore the exploding costs of a middle-class tax crisis under the AMT that we will almost certainly have to finance.

Looking at that and looking at continuing to deal with the AMT exemption every year, roughly $50 billion a year on average from now until 2012.

How do you do all of that, not offset the tax cuts? How is that fiscally responsible? Would you have run your former company that way? You would have? Would you have run your former company that way?

Secretary PAULSON. I would say that looking at a firm, there is an appropriate role for debt. And again, as I look at the fiscal situation—and you missed some of the discussion we had earlier, so I will repeat it—we have a situation today where our debt as a percent of GDP, is 1.8 percent. Looking over a period of time, that is within a range that I do not think would concern many—

Chairman CONRAD. Mr. Secretary, might I just stop you for a moment, because I think you just misspoke. You said our debt is 1.8 percent. I think you meant to say our deficit.

Secretary PAULSON. Deficit, absolutely. I am sorry. Thank you.

And so I look at it from that perspective, I was at the House Budget Committee yesterday and Chairman Spratt looked at our budget and said, I do not believe you are going to balance it in 2012. He said, I think that instead of having a surplus you are going to have a deficit, and it is going to be $145 billion with your policies.

I said that I think we will achieve a surplus or balanced budget. But if he is right, the deficit would be 0.8 percent of GDP.

The concern that all of us have, and the reason we have the fiscal concern, is because of what we see coming with the entitlement program. I think there was sort of a general agreement, before you had come in, that that is the issue.

And so if I were running a company and I was looking—

Senator MENENDEZ. So the answer is yes? The answer is yes? Is that what you are telling me, this is how you would run your company?

Secretary PAULSON. I would say it is not a simple yes or no. I would say that a deficit of this level right now would not concern me. But if I was looking at accrued liabilities staring me in the face a number of years down the road, I would be very concerned. And I would ask how do we deal with it.

Senator MENENDEZ. Let me ask you about values because I think budgets are about values, both personally and nationally.

How is it that we can explain a value that we have $1.7 trillion in tax cuts, including those that would provide $160,000 break to millionaires in 2012 and not have an extension of the college tuition deductibility when we are more globally competitive than ever before?

Is that a value that make sense?

Secretary PAULSON. I would say that, as far as I know, the college tuition deduction is in the law now.

We did not put in the budget a proposal to extend it, but it is there thorough 2007?

Senator MENENDEZ. The deduction expires at the end of 2007.

Secretary PAULSON. We did not include an extension.

Senator MENENDEZ. You did not. So it is evidently not a value the Administration decides is a value.

Secretary PAULSON. I would say education is an important value.

Senator MENENDEZ. But not when we take away the single most significant way that average middle class and those struggling to get into the middle class have to help them fund their education. Yet, we have these tax cuts geared in such a way that clearly speak of a different set of values.

Let me ask you this, speaking of values. The overwhelming part of the tax paying base of this country is the middle class. How is it possible that if we make the tax cuts permanent, what is the cost of the long-term AMT relief? It is a lot more, is it not?

Secretary PAULSON. Yes. The long-term AMT relief is something that is very important to all of us. And it is a cruel and unintended tax. And we are very committed to coming up with a permanent solution there.

Senator MENENDEZ. It seems to me, Mr. Chairman, and I see my time is up and I do not want to belabor it before my colleagues, that addressing the pretax cut AMT issue relief would be about $400 billion, compared to about $3 trillion of the cost of AMT relief with extending the tax cuts.

So I just do not believe, I have been here 15 years—not in the Senate but in the Congress—and I just do not believe that everything I hear is that we can have it all. It is like having a kid in a candy store. We can have it all, do not have to pay for it, do not have to be worried about any consequences, not going to affect the domestic discretionary spending, not going to hurt programs that help people achieve the goals in their lives and fulfill the American dream.

I am just bewildered by the Administration's testimony that constantly leads down that road.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman.

Mr. Secretary, it is a pleasure to have you before the committee. I think you are very much committed to trying to deal with the long-term budget problems that we have. Our chairman has held a series of hearings on the long-term challenges that we face, not just the 2008 budget. I look forward to working with you.

But I just want to comment that there are several elements of this budget that make it more difficult for us to move in that direction. Senator Menendez mentioned the alternative minimum tax. We all agree we have to deal with it. Yet, the budget does not provide any relief beyond 2008.

And I mention that specifically because, you have said that we will bring it into the budget debate at some point. But the budget does talk about Social Security. That is an area that you and I have talked about, and I think it is important that we strengthen Social Security, and that we do this on a bipartisan basis.

But the budget includes, in 2012, the privatization of Social Security and diversion of funds. I do not think that is very helpful in trying to get a commitment to deal with Social Security.

I believe you strengthen Social Security by strengthening it. Adding additional burdens, such as privatization does in 2012, does not make it easier for us to deal with it.

Secretary PAULSON. Would you like me to respond to that?

Senator CARDIN. Absolutely.

Secretary PAULSON. Absolutely.

First of all, let me say I know how committed you are to retirement security. I have appreciated our conversations and I look forward to having more of them. I also know you are very knowledgeable in this area.

With regard to the personal accounts, it should not surprise anyone that the President had a plan he put out. It was a plan, personal accounts were part of it. He thinks personal accounts are a good idea. So it should not surprise people that personal accounts are in the budget.

I hope you did notice that they were put off a number of years. And I hope you see an important signal in that.

But what the President has said, and what I have said, is we would really like people from both sides of the aisle to come together without any preconditions to talk about their ideas.

So again, it should not surprise people that one of ideas that the President will have is personal accounts. That does not mean that you are going to like it, that other people are going to like it. But again, as I have talked with people individually about it, although there has been some push back publicly, most people have said how can you tell people to come to the table and tell them that you cannot talk about one idea or another. All ideas should be welcomed, and we will work through it.

When you and I talked individually, I understand what you think about personal accounts.

Senator CARDIN. And it has not changed.

Let me assure you that I am interested in talking about supplemental accounts, and other ways that we can improve private savings and retirement, in addition to Social Security. I think that is important. I think we have a responsibility to strengthen Social Security, but we also have a responsibility to increase private savings and retirement in addition to Social Security.

We have heard over and over again, during our hearings on long-term budget issues, that we must increase savings rates, deal with national savings, and correct the trade imbalance through increasing national savings.

So when I have a chance to talk to the USTR about the trade imbalance, you are always mentioned. As the Secretary of Treasury, you have the responsibility for the currency issue with China.

And China cannot justify its currency practice. I must tell you, we are running out of patience in the United States Senate on this issue. I expect you will see some activity that will take place.

It would be far better if we could negotiate an orderly process for China to allow its currency to reach its appropriate market rate, rather than tying it to the United States dollar.

Secretary PAULSON. Senator, I have that message loud and clear. I testified before Senator Dodd's committee on January 31st, and I will be very brief in just saying to you that we have a process in place. I do believe the strategic economic dialog lets us speak with one voice on a regular basis to the decisionmakers of China, and that we are pressing for much greater flexibility and movement in their currency in the short term. And they have been moving it, and they have been moving it more quickly, but it is not nearly quickly enough.

But we are also working on some structural things they need to do to get to the point so we will not be having the debate about what is the appropriate level. They will have a market determined exchange rate.

And then what is really underlying your question are the imbalances. When you look at the imbalance in order to get at that, as important as currency is—what really gets at the imbalance are structural changes. And so, when we are not saving, and I know you understand this very well, and when they are saving at 50 percent, and they have an economy that does not have domestic-led consumption, but is led by exports, and we are growing, we are going to have these imbalances.

And so, again, we are working on some benchmarks and working toward progress on the kinds of intermediate-term and longer-term structural change they need to make to really open up their economy.

And to the extent they open up for more competition for United States products, more competition in the services area, and get some structural changes, that will make a big difference.

The one positive thing I mentioned before you came in, is that this year we reached the crossover point on exports. And every quarter for the last four quarters our exports have been growing faster than imports in this country. And this last year our exports to China grew 33 percent, our imports 19 percent. And because exports grew faster than imports for our country they added a percentage point to our GDP in the fourth quarter.

So we are making progress. We have more to do. I have the message. You gave it to me when we talked to you personally. I have it here. I know what I need to do. We need to get some progress.

Senator CARDIN. I would just point out the urgency of this matter. Each month there are more and more United States companies that cannot compete with a 40 percent discount given to Chinese products and more American jobs are being lost. It is truly urgent.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Cardin.

If I can go back to the question of what is in this budget with respect to tax increases, you had earlier stated in your testimony, in response to a question from Senator Bunning, you would not recommend a tax increase. We talked about the alternative minimum tax and you defined a tax increase as one where you failed to extend expiring tax provisions, with respect to the 2001 and 2003 tax cuts. AMT, that expiring provision, because you only handle it for

1 year in your budget, is a $500 billion tax increase contained in your budget.

I started looking at other tax provisions that you do not extend or extend for just a brief period of time: work opportunity and welfare to work credits, you only extend for 1 year in this budget. So you have 4 years of a tax increase there.

State and local sales tax deduction in the budget presented by the President, not extended at all. Not even for 1 year. That is a whopper of a tax increase for people.

Deduction for qualified college tuition, that is not extended at all. And under your definition that would be a tax increase. That is a big tax increase for people who have kids in college.

Depreciation of leasehold improvements, something I have been very involved in, the Administration's budget does not extend that at all. That would be a big tax increase for business.

Indian employment tax credit is not extended at all. The renewable energy credit, the energy efficient building credit, the bio-diesel credit, the energy efficient home credit, the clean renewable energy bond, solar and fuel cell credits, none of them are extended in this budget. All of them, under your definition, are a tax increase.

So this budget that the President sent up here, the more time I have to examine it, is filled with tax increases by your definition, is it not?

Secretary PAULSON. Well no, I would not say that. Let me start with the big one and just say again, because Senator Cardin was not here when I said it before, what we did on AMT was put in an additional year of relief, the 1-year patch, which as you know has gone on for 6 years. We have said that this is a tax that is unintended and cannot go into effect without extending the patch.

Chairman CONRAD. But you used the revenue to balance the budget, Mr. Secretary.

Secretary PAULSON. We want to work on it together.

Now with these others, I would not read anything into this. These expiration dates are set by Congress, they are not set by us. And we will have a chance—

Chairman CONRAD. But Mr. Secretary, let us be frank now. Do not hurt your credibility here. Do not hurt your credibility.

You cannot, on the one hand, say if the 2001 and 2003 tax cuts that are going to sunset. And if we fail to do that you call it a tax increase. And then in all these other tax provisions that are set to sunset and you do not extend them in your budget, by simple definition, your definition, these are tax increases.

And this budget, as I have a chance to examine it, you have hundreds of billions of dollars of tax increase. At least you are using the revenue to balance.

Secretary PAULSON. I would say, Mr. Chairman, as I think about tax increases, there are a lot of fine points of the whole budget process that are rather Byzantine to me. But I would say to you, in terms of the taxes you are talking about, I have no doubt that if and when any of them expire and the tax goes up, the person that pays that tax will know it is a tax increase.

Chairman CONRAD. Well then, everyone of these, by your own definition, they have an awful lot of people who should be told the budget the President has sent up here is loaded with tax increases.

Secretary PAULSON. They have not expired yet.

Chairman CONRAD. You do not extend the state and local sales tax deduction for even a year. You do not extend the qualified college tuition for even a year, that deduction, or the renewable energy credit or all of the others I have listed.

So I would just say to you, if we are going to be frank with each other, if not extending the 2001 and 2003 credits constitutes a tax increase, then all of these others constitute a tax increase because the budget the President sent up your does not extend them.

Secretary PAULSON. I would say that they will be a tax increase when the taxes actually go up.

Chairman CONRAD. But the budget guides policy around here. And in the President's budget, he does not extend them. So the taxes are going to go up unless we take action. The President has used the revenue to balance his budget.

Let me just indicate, there is a vote that has now started.

Senator Whitehouse.

Secretary PAULSON. Shucks.

[Laughter.]

Chairman CONRAD. Mr. Secretary, you are saved by the bell.

Secretary PAULSON. You have ruined my morning. I wanted to go all the way to noon.

Chairman CONRAD. All right we will, first of all, thank you again for your appearance here. Thank you for your service to the country. And we will close the hearing. I understand the Secretary is leaving for a trip, as well, and we wish you well.

Secretary PAULSON. Thank you very much.

[Whereupon, at 11:57 a.m., the Committee was adjourned.]

RESPONSES TO QUESTIONS FOLLOWING THE TESTIMONY OF SECRETARY PAULSON BEFORE THE SENATE BUDGET COMMITTEE ON THE PRESIDENT'S FISCAL YEAR 2008 BUDGET

Department of the Treasury
March 30, 2007

Lautenberg Question 1

In the past, as the Chairman of Goldman Sachs, you have advocated for a reduction of carbon dioxide by U.S. industry.

With businesses such as DuPont, G.E. and others, stating that reduction of greenhouse gases is in their business interest, why does the Administration continue to say that strong global warming legislation is "bad" for business?

Answer

Ambitious efforts to reduce greenhouse gas emissions would have benefits, but would also impose costs. Any policies to prompt such reductions should ensure that those costs are minimized and that they are justified by the associated benefits from mitigating the risks of global climate change.

I understand the desire in some parts of the business community for more certainty about the course of future greenhouse gas policy in order to help make investment decisions Nevertheless, in my opinion it is unwise to resolve regulatory uncertainty by prematurely committing to a course of action that could lead us to suffer more economic harm than otherwise might be necessary.

Looking forward, technologies that limit the quantity of greenhouse gasses in our atmosphere will be critical to successfully mitigating global climate change without significantly disrupting economic growth. U.S. firms will undoubtedly play an important role in developing and deploying these new technologies.

Nelson Question 1

The President has claimed to balance the budget in FY2012 without raising taxes. Yet under your revenue assumptions taxpayers in Florida who currently can deduct their state and local sales taxes would see their tax bills rise over $3 billion based on the President's budget.

The Administration repeatedly has said that a failure to extend expiring tax cuts amounts to a tax increase. I am interested to know how you can continue to make that claim when taxpayers in non-income tax states will be paying $10.4 billion more in taxes over the next five years if Congress were to use your revenue assumptions.

Is this not a tax increase? And does the President no longer support the deduction for state and local sales taxes?

Answer

The Administration does not believe that taxes should be increased by permitting the 2001 and 2003 tax cuts to sunset at the end of 2010. Those tax reductions were intended to be permanent, and the sunset provision was included only to meet technical budget requirements in the Congress. The optional itemized deduction for state and local sales taxes was enacted in 2004 as a temporary measure for 2004 and 2005 only. It was extended, again temporarily, last year for 2006 and 2007 only.

While the Administration has not included an extension of the itemized deduction for state and local sales taxes in any of its budgets, if the federal income tax treatment of state and local taxes is to be addressed, we believe it would be better to do so as part of a broader tax restructuring. We look forward to working with the Congress to restructure and improve the federal tax system.

Bunning Question 1

I would like to explore the effects that the lower capital gains tax rate has had on the level of federal tax revenues. According to the nonpartisan Congressional Budget Office, tax receipts in 2006 were $253 billion higher than in 2005, and tax receipts in 2005 were $274 billion higher that in 2004. Some of these increases came from non-withheld taxes which include taxes on dividends and capital gains. In its latest Economic Outlook, the CBO reports that realizations of capital gains grew by about 13 percent in 2006, 29 percent in 2005, and 54 percent in 2004.

In January 2004, CBO forecasted that tax liabilities from capital gains for calendar years 2003 through 2006 would be $197 billion. Now, with actual figures for 2003, 2004 and 2005, CBO expects those tax liabilities to be $330 billion - that's $133 billion more than previously projected. This rising revenue pattern is good news for the federal budget, but it probably doesn't tell the whole story, as these tax cuts have also contributed to shareholders receiving more dividends and to a growing economy that is producing more tax revenues. The correlation between lower tax rates and increasing capital gains realizations can't be denied.

Under current law, the 15 % capital gains rate is scheduled to go back up to 20% at the end of 2010, and dividends will be taxed at ordinary income rates as high as 35% (or 38.6% after 2010). The Administration has called for making the lower rates permanent, and has estimated the cost over the next ten years to be $90 billion for dividends and $79 billion for capital gains.

Mr. Secretary, would you comment on the effect the lower dividends and capital gains rate has had on the federal budget over the past 4 years, the effect of making the rate cut permanent, and the consequences of allowing it to expire?

Answer

At the time the rate reductions were introduced, Treasury estimated the tax rate reductions for dividends and capital gains would cost approximately $60 billion over the four fiscal years 2004-2007. Currently, we estimate that the FY2008-2017 cost of extending the dividend and capital gains rate reductions permanently is roughly $170 billion.

Allowing the dividend and capital gains tax rate reductions to expire would increase several tax-induced distortions that encourage firms to use debt rather than equity finance, to adopt unincorporated rather than corporate structures, and to retain earnings within the firm rather than distributing them. Each of these distortions would contribute negatively to economic growth, and may also induce higher bankruptcy risks during economic downturns.

Making the tax rate reductions on capital gains and dividends permanent – rather than simply extending them by a few years – likely would reduce these distortions further because firms would expect a permanently changed tax structure.

Historically, capital gains realizations and their associated tax receipts have been volatile, and have had a strong relationship to asset market prices. Because of this, forecasting tax receipts from capital gains accurately is quite difficult, and it is not always possible to determine with confidence how much realizations have been affected by tax rates or many other factors. We do believe that the tax rate reductions affecting capital gains and dividends have caused higher levels of gains realizations and dividend payouts. Nevertheless, non-tax factors, such as the run-up in asset values, which itself may have been partly due to this tax relief, also are likely to have contributed to the large increases in capital gains realizations observed over past few years.

Sessions Question 1

During his testimony last year, former Treasury Secretary John Snow indicated his belief that the Government should not get into the business of tax preparation. In light of the ongoing successes of the privately run Free File Alliance, which has made it easier for more than 95 million eligible taxpayers to electronically prepare and file their tax returns, does the Administration's position remain the same?

Answer

To date, the IRS has avoided getting into the electronic tax preparation business because private industry has established expertise and experience in this area, and has a proven track record in providing to taxpayers the best technology and services available. The IRS has worked to encourage growth in this area by collaborating with private industry in developing the Free File program, which makes tax return preparation software and electronic return filing available to 95 million Americans. In 2006, almost 4 million returns were filed under the Free File program and, as of February 22, 2007, the IRS had received over 2 million returns through this program.

Issues of access, capacity, privacy, security and cost continue to make the IRS reliant on the private market to provide free electronic return preparation software. The success of the Free File program demonstrates that continued reliance on private industry in this area is appropriate.

THE PRESIDENT'S FISCAL YEAR 2008 BUDGETARY PROPOSALS FOR THE DEPARTMENT OF HEALTH AND HUMAN SERVICES

TUESDAY, FEBRUARY 13, 2007

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:07 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Feingold, Nelson, Menendez, Cardin, Whitehouse, Gregg, Allard, Bunning, Crapo, and Cornyn.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

Chairman CONRAD.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. The hearing will come to order.

We thank everybody. Senator Gregg is on his way.

Secretary Leavitt and I have just had a chance to talk about some things that are important and some of those things we will talk about as the hearing progresses.

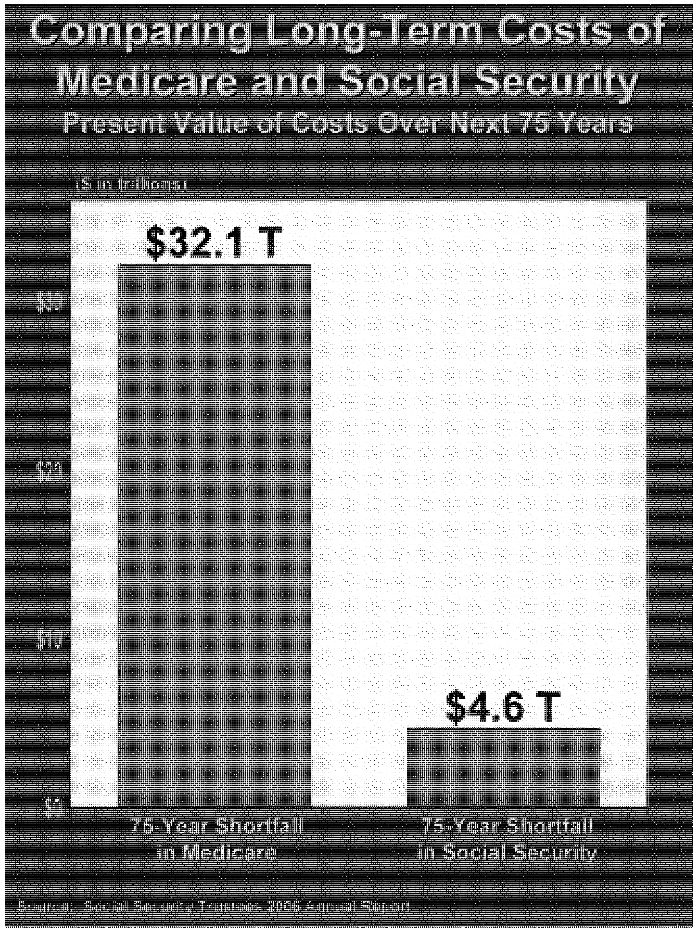
We especially want to welcome Secretary Leavitt to the committee. We thank him for his service. We thank him for his excellent leadership. And we very much appreciated the opportunity to work with him and have enjoyed the relationship.

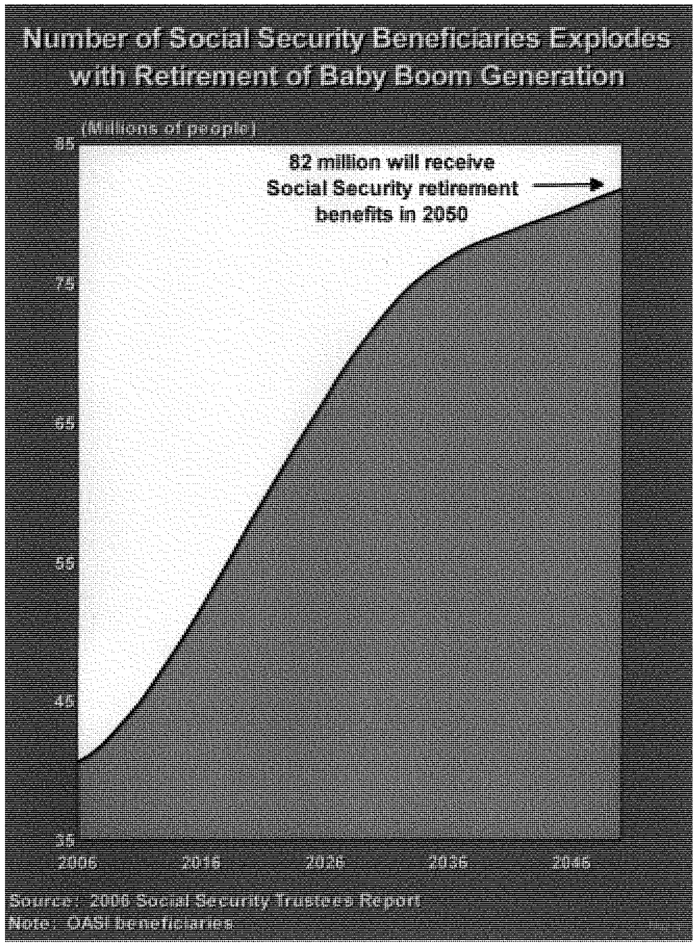
This is an important hearing because our Nation's physical health is directly linked to our fiscal health and the challenge of Medicare and Medicaid and the other health accounts is among the most daunting that we face. I personally believe it really is the greatest challenge. It is the 800-pound gorilla. And together we have to find ways to address it, and the sooner the better.

We know that we face a demographic tsunami. We have this baby boom generation that is poised to retire. They are out there. This is no projection. They are alive. They are going to retire. They are going to be eligible for Social Security and Medicare.

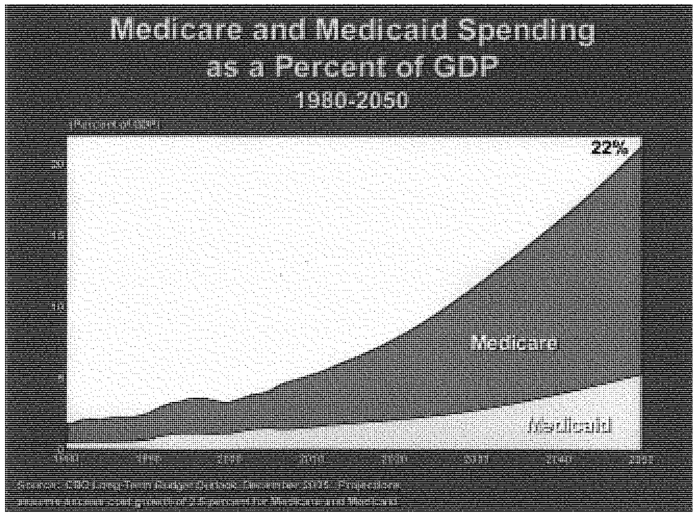
This is a chart that shows what happens. It is unlike anything we have ever seen before, which I think is one reason we find it difficult to cope with. It is just not something in our experience.

We need to remember that Social Security is not the biggest budget challenge confronting us, although it is certainly part of the puzzle. But the biggest part, by far, is Medicare. We see the comparison here. The 75-year shortfall in Medicare, over $32 trillion, seven times as much as the projected shortfall in Social Security.

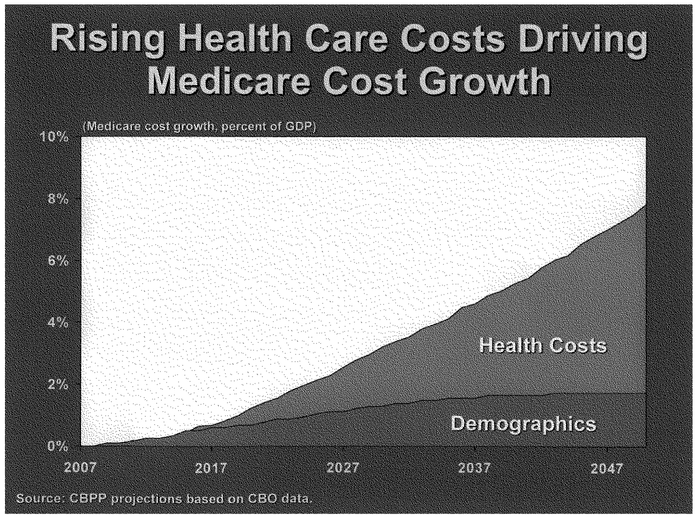




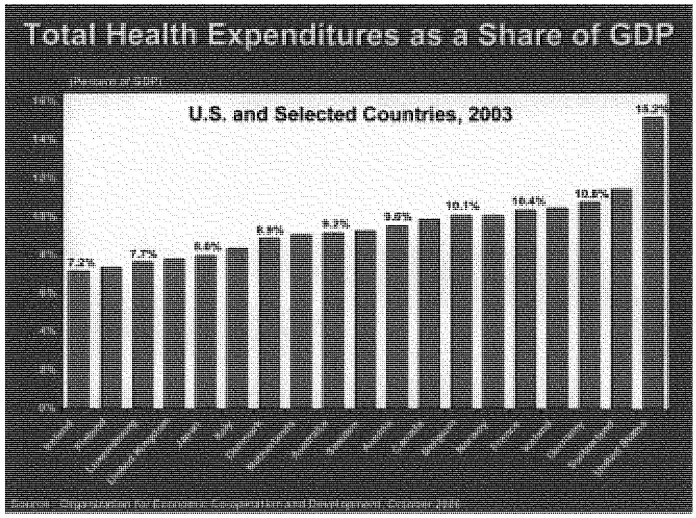
The growing cost of Medicare and Medicaid is simply staggering. By 2050, if nothing changes, more than 20 percent of our gross domestic product, 20 percent of our economy, will be spent on just these two programs. That is as much as now goes up for all of Government. So we are clearly on a course that is unsustainable if the current trend lines continue.



This next chart from the Center on Budget and Policy Priorities shows that rising health care costs are by far the biggest factor driving Medicare cost growth. Demographic changes are a significant but secondary factor. So the biggest driver of all of this is rising health care costs. The demographics clearly play a role, an increasingly significant role. But the thing we have to remember is that it is underlying health care costs that are the biggest driver.

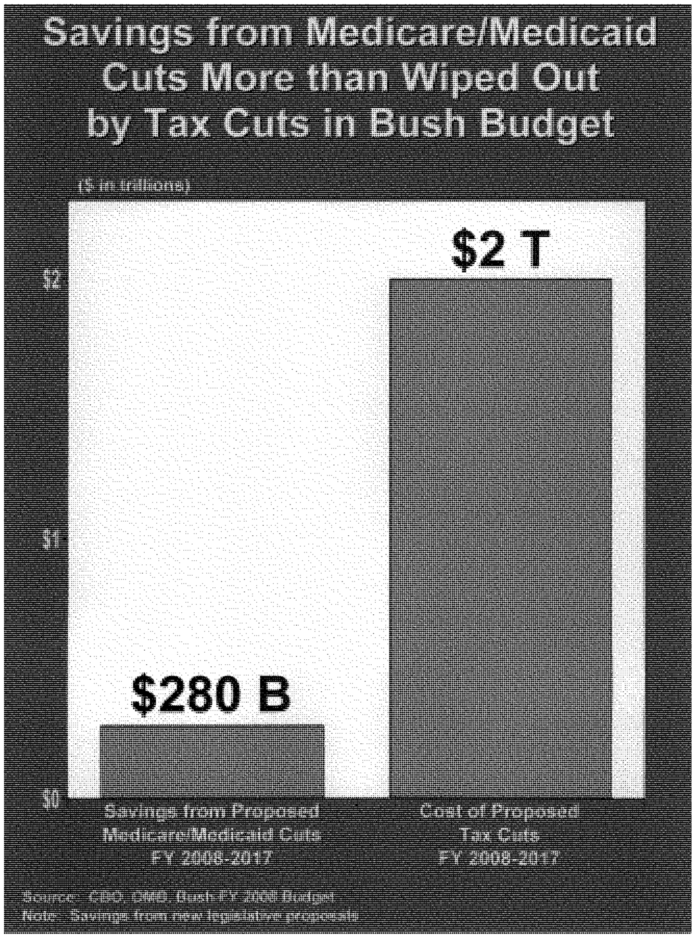


The fact is that our health care system is not as efficient as we would like it to be. The United States is spending far more on health expenditures as a percentage of our gross domestic product as any other country in the developed world. Those are the leading economies in the world. For example, the United States, we are at 15.2 percent of gross domestic product. Back in 2003, these are the last international numbers, we are making an international comparison here, we know that our spending now has reached 16 percent of gross domestic product.

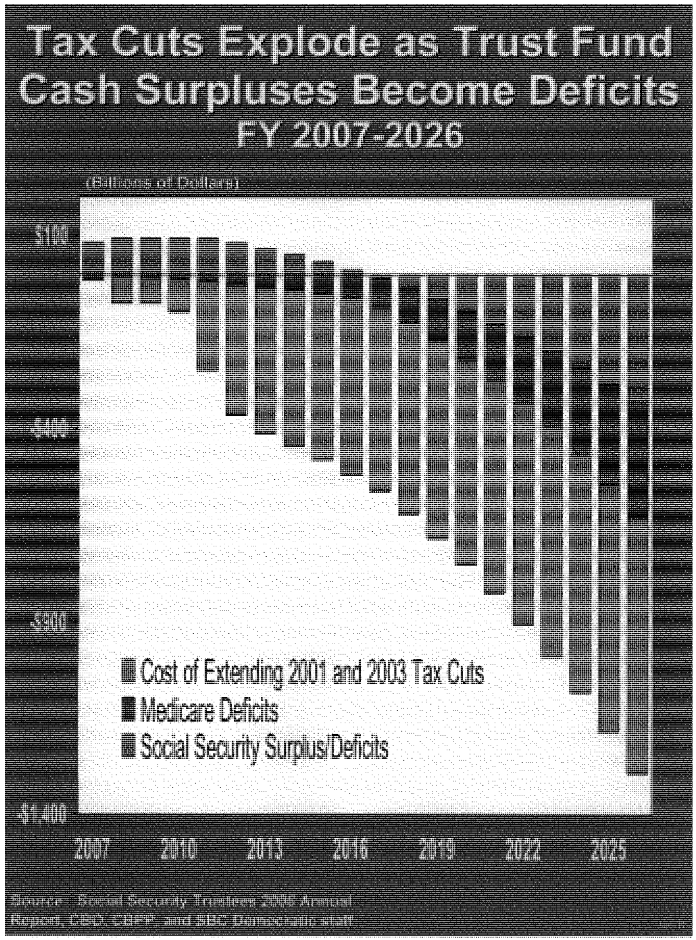


The next highest country when this was done was Switzerland at 11 percent of gross domestic product. That difference between 11 percent and 16 percent of gross domestic product is $800 billion in a year, $800 billion in a year. That would completely take care of not only our on-budget deficit but our off-budget deficit, as well.

Unfortunately, the budget before us does not deal with the underlying problem of the rapid growth in health care costs. Clearly, we are going to have to find savings in the entitlement accounts. The President's Medicare and Medicaid cuts will save $280 billion over the period 2008 to 2017. But those savings would be more than wiped out by the $2 trillion in tax cuts the President also proposes, tax cuts that are not paid for.

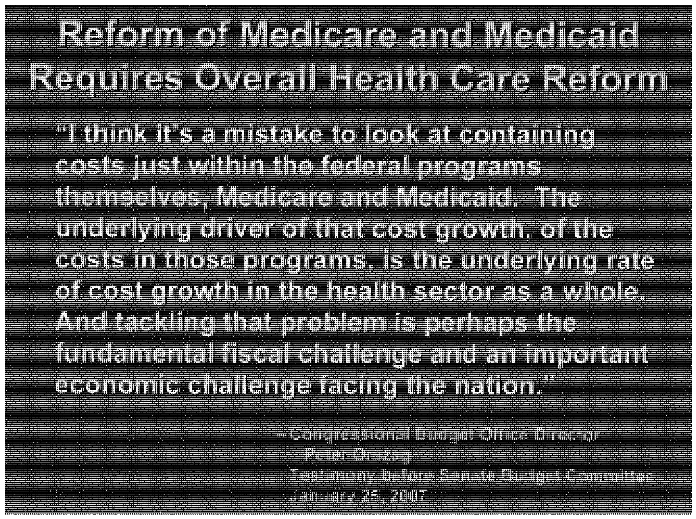


If all of the 2001 and 2003 tax cuts are made permanent, the cost will explode at the very time the cash surpluses in Social Security and Medicare become deficits. In other words, the tax cuts will dramatically worsen an already serious situation.



I am talking now about tax cuts that are not paid for. I would be delighted to be able to continue all of the tax cuts. I have been a significant beneficiary of those tax cuts, and many of my constituents have. But we have a very serious problem making things add up here.

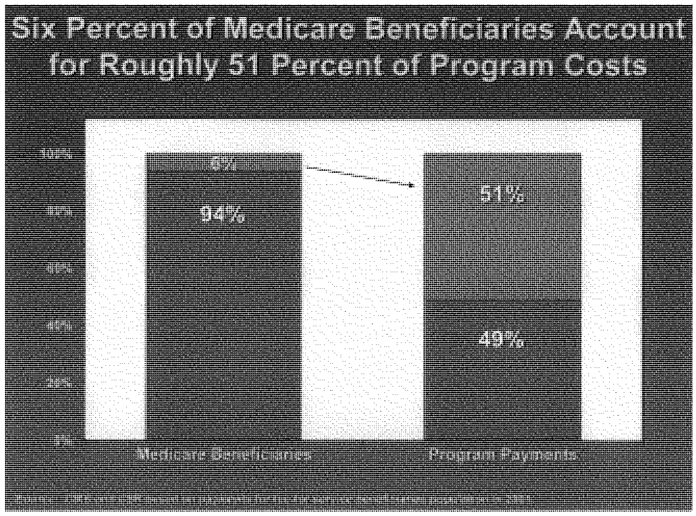
I am not the only one who believes that changes to Medicare and Medicaid should be done in the context of overall health care reform. Here is what our new CBO Director told us in his recent testimony before the committee, and I quote, “I think it is a mistake to look at containing costs just within the Federal programs themselves. The underlying driver of the cost growth—of the cost of those programs is the underlying rate of cost growth in the health sector as a whole. And tackling that problem is perhaps the fundamental fiscal challenge and important economic challenge facing the Nation."



Let me just say I believe that. I endorse that. I think that is precisely what we have to face up to.

And we are delighted, Secretary Leavitt, that you are here today to discuss these issues and others.

Let me just conclude by going back to one of the things that I have returned to repeatedly, and my colleagues know it well, is this notion of those who are chronically ill. Because there 6 percent of the population, 6 percent of the beneficiaries are using half of the budget. When I went to business school they told us to focus on that, any time you find a statistic like that, where you have a small percentage of the population has a disproportionate share of the cost. That is really where we have to first focus our attention. We will have more chances to talk about what we might do in that area.



Again, welcome, Mr. Secretary. And now I will turn to my colleague, Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. It is a pleasure to have the Secretary here to talk about the health care elements of the President's budget.

I obviously agree with the groundwork laid by the Chairman on the issue of the problem, which is the demographic shift in our population that we are going to have to support as a Nation and what the effect of that will be, and the fact that a large percentage of the issue is health care and how you deliver quality health care to 80 million retirees versus 35 million retirees and do it in a way that does not bankrupt the younger generations who are paying for it.

Where I think we depart ways, of course, is that I am willing to step forward, and I admire the Administration and respect the Administration for stepping forward with some specific proposals right now and not to play the verbal game of well, if we just did it on a global basis, if we just did this, if we just did that, we might be able to accomplish this or that. I think you have to have specific proposals.

The proposal the Administration has put forward is a legitimate specific proposal which would reduce the long-term unfunded liability of Medicare by almost 25 percent. That liability is approximately $32 trillion. That is not a sustainable liability for us to pay for.

What the Administration has suggested is major changes in Medicare which do not affect beneficiaries, certainly do not affect poor beneficiaries or moderate income beneficiaries, but rather give us a better accounting of the costs of health care and reimburse on that better accounting system, and also require high income people to pay a fair price for the benefits they get from the Government. Specifically, Bill Gates's father should not have his Part B physician premium subsidized and he should not have his Part D drug premium subsidized at the rate that we subsidize it.

These changes are very appropriate and they save significant dollars over the term and move us toward—closer in the direction of solvency, which is very appropriate.

What has been the Democratic response so far? Well, I have heard, not the Chairman—in fact, I think the Chairman has been very responsible on this. But members on his side of the aisle who represent the ideology of the Democratic Party, or at least they assert that they do because they are running for president, saying that these Medicare proposals of the President's are cuts, they are slashes to the system, they are a dramatic disassemblage of the system. And of course, they are not anything like that.

They are very reasoned, very appropriate attempts to try to bring under control a system that is not going to be sustainable. What will be a slashing to the system is if we continue on the path that we are presently on, which will give our children a system they cannot afford and give the retired people a system that cannot be paid for. So starting now make sense.

A second idea that has come forward from the other side of the aisle and has now passed the House and which I know the Secretary is very familiar with because it tells the Secretary, is to give the Secretary the authority to negotiate drug prices relative to the Part D premiums. What is the practical effect of that? Well, you cannot have that authority unless you also have a formulary, we all know that, which is a list of drugs that would be acceptable because that is where the club comes from.

So what essentially it is is a rationing proposal. What the other side of the aisle is suggesting that our senior citizens should have their drugs rationed, and the decision on what they want and what they will not get will be decided by the Secretary of HHS, whoever that person may be.

It is put forward in the motherhood language of negotiating drug costs but the practical effect would be that, like veterans, who only have the access to about 37 percent of the drugs that are on the market today, American citizens would no longer have access to all of the drugs that are out there, which would reduce their quality of life. And we have seen the marketplace has had a fairly significant impact on pricing of drugs relative to Part D, so much so that we have saved almost $100 billion off the baseline in that program as a result of the competition.

So to go to a system of rationing seems to fly in the face of what is working, which is a market oriented system. But that is the proposal from the other side of the aisle.

So I look forward to the Secretary's outlining in further detail the Department's position, both relative to Medicare and its proposal, and relative to the rationing proposal that the Democratic party has put forward as the essence of their health care plan.

I also look forward to the Secretary giving us some thoughts on how we deal with Medicaid because states are being overwhelmed by the cost of Medicaid. We are not doing a very good job of managing Medicaid. And I would be interested in his thoughts relative to using the States as more aggressive incubators of ideas in the area of Medicaid. Having been a former Governor, I know he has been very aggressive in that issue.

Thank you.

Chairman CONRAD. Thank you. I would just say to my colleague, I do not know if he was able to see the press from over the weekend but on the question of income relating Medicare, I said this weekend I think that has to be done.

Senator GREGG. I think I was very—I hope I gave you enough praise for your position, which is what I think is a correct position. And you have been a voice of reason on the issue.

Chairman CONRAD. Let me just say, I do not, for the life of me, I cannot understand how it is progressive in any way to have very wealthy retirees being subsidized by working families. It makes no sense to me and we cannot continue that, of course, in my judgment.

When I look at what is going to have to be done here, that is one thing that is going to have to be part of a solution. I think the Administration was constructive in putting it forward.

There are other things the Administration has proposed, we will have a chance to get into momentarily, that I have a less favorable view of. But I thank my colleague for raising the issue.

Thank you, Mr. Secretary, and please proceed with your testimony.

STATEMENT OF HON. MIKE LEAVITT, SECRETARY, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary LEAVITT. Thank you, Mr. Chairman, Senator Gregg, and members of the committee.

Mr. Chairman, I have submitted a statement that I would like to have entered for the record.

Chairman CONRAD. Without objection.

Secretary LEAVITT. Thank you.

I would like to take a few moments and just give you a sense of overview of the way we went about creating this budget. As you know, a budget of this size takes hundreds of people and is worked on over the course of a year, and requires guidance from the Secretary as well as guidance from the President. The President very clearly wants this to be a deficit reduction budget.

And so when we are dealing with deficit reduction, we are dealing with priority selections that we have all had to deal with. They are hard. I have made decisions that some of you will disagree with. I am here to basically give you a good sense of the rationale for that. But I would like to give you a sense of the guidance that I gave my colleagues as they went into the tens of thousands of individual decisions that made it.

First, may I comment on the issues related to the entitlements. I am here as Secretary, but I also wear the mantle of a trustee of the Medicare Trust Fund. As we began work on this deficit reduction budget, it was clear to me that those things had to be dealt with as well. The proposals that I have made today, I am prepared to defend on each of the specific issues. When you roll them all up, they come up with a sum of money. But there is a whole series of individual decisions that have been made that I think bear scrutiny and I am prepared to defend them.

I will say that as we started into it I told my colleagues, I want this to be about weight loss, not amputation. And each one of these reductions in the growth rate that we have made, that add up to a lot of money when they get out into the future, have been thought through in a way that I believe can be defended.

If we put them all together on that graph that you created, they still only make the Trust Fund sustainable from 2018, it goes out to 2022. So there is a lot more work to be done but this is at least a start and the kinds of things that we are all going to collectively have to face.

With respect to the discretionary budget, may I say that I gave my colleagues four basic priorities to follow if they were going to add anything to this budget. The first is I wanted to focus on high demand highly efficient programs, and you will see that we have protected some programs like the Indian Health Service and Head Start and the way we treat refugees and so forth.

You will also see that there are some Presidential initiatives that I wanted to assure were completed. One of them is the community health centers. The President made a commitment for 1,200 of them. This budget completes that. The commitment we made to HIV/AIDS, this continues that. The commitment we have all made to fight pandemic, this continues that effort.

It recognizes there are new pressing needs that have not been contemplated before, like the FDA and drug safety. You will find initiatives in that area.

Then You will find a series of things that we have approached before that have not been funded to the degree that I believe they need to be. One is health IT. Right at the center of that cost problem is the need for electronically connected records.

Now turning to the savings side of this budget, I gave my colleagues a series of guidelines that I wanted them to follow. For example, you will see situations where we have not repeated one-time funds. There will be a lot in this group that are a fan, like I am, of CDC. We have undertaken a big building program there. You will see that CDC's budget is not what it was last year because we did not repeat those one-time funds.

You will see that I have given a bias to direct services, as opposed to just building infrastructure. I suspect we will talk about health professions. That budget has been reduced in favor of having more community health centers. That is an example of the tradeoff I am talking about.

You will see that I have looked for grant programs, grant activities that may have reached the conclusion of their activity and I have not automatically proposed those be renewed. A good example of that is the National Cancer Institute, where we have more actually competitive grants that will go out but the actual budget itself is slightly smaller.

I have also looked for under performing programs, I have looked for reductions. I have offered some reductions we have offered before, for example in Medicare again, the issues related to durable medical equipment. We had an opportunity to talk about that. I think there is a lot of fraud in that area and I think there are things we can do to reduce it.

But that will give you an overview of the kind of guidelines. And as we talk about specifics, I will do my best to put the specifics into that framework.

And I am eager now, Mr. Chairman, to entertain your questions.

[The prepared statement of Secretary Leavitt follows:]

Testimony

Before the
Committee on the Budget
United States Senate

FY 2008 Budget Request for the Department of Health and Human Services

Statement of

Michael O. Leavitt

Secretary
U.S. Department of Health and Human Services

February 13, 2007

FY 2008 Budget Announcement

Chairman Conrad and Senator Gregg, thank you for the invitation to discuss the Department of Health and Human Services' budget proposal for fiscal year 2008.

For the past six years, this Administration has worked hard to make America a healthier, safer and more compassionate nation. Today, we look forward to building on our past successes as we plan for a hopeful future.

The President and I have set out an aggressive, yet responsible, budget that defines an optimistic agenda for the upcoming fiscal year. This budget reflects our commitment to bringing affordable health care to all Americans, protecting our nation against public health threats, advancing medical research, and serving our citizens with compassion while maintaining sensible stewardship of their tax dollars.

To support those goals, President Bush proposes total outlays of nearly $700 billion for Health and Human Services. That is an increase of more than $28 billion from 2007, or more than 4 percent. This funding level includes $67.6 billion in discretionary spending.

For 2008, our budget reflects sound financial stewardship that will put us on a solid path toward the President's new goal to achieve a balanced budget by 2012.

I will be frank with you. There will never be enough money to satisfy all wants and needs, and we had to make some tough choices.

We take seriously our responsibility to make decisions that reflect our highest priorities and have the highest pay-off potential. We recognize that others may have a different view, and there are those who will assume that any reduction signals a lack of caring. But reducing or ending a program does not imply an absence of compassion. We have a duty to the taxpayers to manage their money in the way that will benefit America the most.

I would like to spend the next several minutes highlighting some of the key programs and initiatives that will take us down the road to a healthier and safer nation.

Transforming the Health Care System

- Helping the Uninsured

- The President has laid out a bold path to strengthen our health care system by emphasizing the importance of quality, expanded access, and increasing efficiencies.
- The President's Affordable Choices Initiative will help States make basic private health insurance available and will provide additional help to Americans who cannot afford insurance or who have persistently high medical expenses.
- It moves us away from a centralized system of Federal subsidies; and,
- It allows States to develop innovative approaches to expanding basic health coverage tailored to their populations
- The President's plan to reform the tax code with a standard deduction ($15,000 for families; $7,500 for individuals) for health insurance will make coverage more affordable, allowing more Americans to purchase insurance coverage.

- *Value-driven Health Care*

- The Budget provides funds to accelerate the movement toward personalized medicine, in order to provide the best treatment and prevention for each patient, based on highly-individualized information.

- It provides $15 million for expanding efforts in personalized medicine using information technology to link clinical care with research to improve health care quality while lowering costs; and,

- It will expand the number of Ambulatory Quality Alliance Pilots from 18 sites in FY 2008.

- *Health IT*

- The President's budget proposes $118 million for the Office of the National Coordinator for Health Information Technology to keep us on track to have personal electronic health records for most Americans by 2014 by supporting our efforts to:

  - Implement agreed upon public-private health data standards.
  - Initiate projects in up to twelve communities based on recommendations of the American Health Information Community. These projects will demonstrate the value of widespread availability and access of reliable and interoperable health information.
  - Develop the Partnership for Health and Care Improvement, a new, permanent non-governmental entity to effect a sustainable transition from the AHIC.

Addressing the Fiscal Challenge of Entitlement Growth

The single largest challenge we face is the unsustainable growth in entitlement programs such as Medicare and Medicaid. The Administration is committed to strengthening the long-term fiscal position of Medicare and Medicaid and to moderating the growth of entitlement spending. The FY2008 Budget begins to address Medicare and Medicaid entitlement spending growth by proposing a package of reforms to promote efficiency, encourage beneficiary responsibility, and strengthen program integrity.

- Medicaid

Medicaid is a critical program that delivers compassionate care to more than 50 million Americans who cannot afford it. In 2008 we expect total Federal Medicaid outlays to be $204 billion, a $12 billion increase over last year.

The Deficit Reduction Act (DRA) that President Bush signed into law last year has already transformed the Medicaid program. The DRA reduced Medicaid fraud and abuse and also instituted valuable tools for States to reform their Medicaid programs to resemble the private sector.

In FY 2008, we are also proposing a series of legislative and administrative changes that will result in a combined savings of $25.3 billion over the next five years, which will keep Medicaid up to date and sustainable in the years to come. Even with these changes, Medicaid spending will continue to grow on average more than 7 percent per year over the next five years.

Along with the fiscally responsible steps we are taking with Medicaid, we are following the same values in modernizing Medicare.

- Medicare

Gross funding for Medicare benefits, which will help 44.6 million Americans, is expected to be nearly $454 billion in FY 2008, an increase of $28 billion over the previous year.

In its first year, the Medicare prescription drug benefit has been an unparalleled success. On average, beneficiaries are saving more than $1,200 annually when compared to not having drug coverage, and more than 75 percent of enrollees are satisfied with their coverage. Because of competition and aggressive negotiating, payments to plans over the next ten years will be $113 billion lower than projected last summer.

We also plan a series of legislative reforms to strengthen the long-term viability of Medicare that will save $66 billion over five years and slow the program's growth rate over that time period from 6.5% to 5.6%.

Similarly, we are proposing a host of administrative reforms to strengthen program integrity; improving efficiency and productivity; and reduce waste, fraud and abuse—all of which will save another $10 billion over the next five years.

Promoting Health and Preventing Illness

We are also taking steps in other ways to transform our health care system. Helping people stay healthy longer also helps to reduce our nation's burden of health care costs. The President's budget will:

- Fund $17 million for CDC's Adolescent Health Promotion Initiative to empower young people to take responsibility for their personal health.

- Strengthen FDA's drug safety efforts and modernize the way we review drugs to ensure patients are confident the drugs they take are safe and effective.

- Enhance FDA and CDC programs to keep our food supply one of the safest in the world by improving our systems to prevent, detect and respond to outbreaks of food borne illness; and,

- Include $87 million to increase the capacity for the review of generic drugs applications at the FDA and increase access to cheaper generic drugs for American consumers.

Providing Health Care to Those in Need

SCHIP expires at the end of FY 2007 and the President's budget proposes to reauthorize SCHIP for five more years, to increase the program's allotments by about $5 billion over that time, to refocus the program on low-income uninsured children, and to target SCHIP funds more efficiently to States with the most need.

The President's budget proposes nearly $2 billion to fund health center sites, including sites in high poverty counties. In FY 2008, these sites will serve more than 16 million people.

We propose increasing the budget of the Indian Health Service to provide health support of federally recognized tribes to over $4.1 billion, which will help an estimated 1.9 million eligible American Indians and Alaskan Natives next year.

We are also proposing nearly $3 billion to support the health care needs of those living with HIV/AIDS and to expand HIV/AIDS testing programs nationwide.

In addition, we are requesting that Congress fund $25 million in FY 2008 for treating the illnesses of the heroic first responders at the World Trade Center.

Protecting the Nation Against Threats

We must continue our efforts to prepare to respond to bioterrorism and an influenza pandemic.

Some may have become complacent in the time that has passed since the anthrax-laced letters were delivered in 2001, but we have not. Others may have become complacent because a flu pandemic has not yet emerged, but we have not.

- The President's budget calls for nearly $4.3 billion for bioterrorism spending.

- In addition, we are requesting a $139 million in funding to expand, train and exercise medical emergency teams to respond to a real or potential threat.

- Our budget requests $870 million to continue funding the President's Plan to prepare against an influenza pandemic. The budget requests funding to increase vaccine production capacity and stockpiling; buy additional antivirals; develop rapid diagnostic tests; and enhance our rapid response capabilities.

- In FY 2008, the Advanced Research and Development program is requested within the Office of the Assistant Secretary for Preparedness and Response (ASPR). Total funding of $189 million will improve the coordination of development, manufacturing, and acquisition of chemical, biological, radiological, or nuclear (CBRN) Medical Countermeasures (MCM).

Advancing Medical Research

The research sponsored by NIH has led to dramatic reductions in death and disease. New opportunities are on the horizon, and we intend to seize them by requesting $28.9 billion for NIH.

Our proposal in FY 2008 will allow NIH to fund nearly 10,200 new and competing research grants, continue to support innovative, crosscutting research through the Roadmap for Medical Research, and support talented scientists in biomedical research.

Protecting Life, Family and Human Dignity

Our budget request would fund $884 million in activities to help those trying to escape the cycle of substance abuse; children who are victims of abuse and neglect; those who seek permanent, supportive families through adoption from foster care; and the thousands of refugees that come to our country in the hopes of a better life.

Our budget request also includes $ 1.3 billion to help millions of elderly individuals and their family caregivers to remain healthy and independent in their own homes and communities for as long as possible, including the $28 million for our Choice for Independence initiative that will help states create more cost-effective and consumer-driven systems of long-term care.

Improving the Human Condition Around the World

If we are to improve the health of our own people, we must reach out to help other nations to improve the health of people throughout the world.

Our budget requests $2 million to launch a new Latin America Health initiative to develop and train a cadre of community health care workers who can bring much needed medical care to rural areas of Central America.

CDC and NIH will continue to work internationally to reduce illness and death from a myriad of diseases, and in so doing will support the President's Malaria Initiative; the Global Fund to Fight HIV/AIDS, Tuberculosis, and Malaria; and the President's Emergency Plan for AIDS Relief.

These are just some of the highlights of our budget proposal. Both the President and I believe that we have crafted a strong, fiscally responsible budget at a challenging time for the federal government, with the need to further strengthen the economy and continue to protect the homeland.

We look forward to working with Congress, States, the medical community, and all Americans as we work to carry out the initiatives President Bush is proposing to build a healthier, safer and stronger America.

Now, I will be happy to take a few questions.

Chairman CONRAD. Well, thanks again, Mr. Secretary. And we do very much thank you for your service. I have found you to be one of the most responsive people I have ever worked with in an administration, and we appreciate very much the way you have been open in your work with members of the committee.

Let me talk about something in the budget that I am not a fan of, and that is the way you have treated the cuts to doctors. As you know, we have a scheduled cut to doctors in their reimbursement of 10 percent. This goes back to the last time there was reform of the entitlement programs and a series of cuts to doctors were put in place that have been on a schedule. And every time one of these cuts comes up, Congress finds a way to put it off and to kick the can down the road. We have done that again and now the next scheduled cut is 10 percent.

We all know that that is not going to happen. But in the Administration's budget, you assume that it will, at a savings of $250 billion, as I understand it, over 10 years.

You know that is not going to happen, we know it is not going to happen. Why does the President's budget assume that we are going to cut doctors 10 percent?

Secretary LEAVITT. I presume the reason that they have done it in the out-years is because that is what the statute would call for absent a statute change.

Let me say I think this system has to be improved. There is no question about the fact that doctors have to have an economic model that will allow their practice to function. But I would suggest that one of the things that needs to change as we look for a better formula is that we have to begin to pay physicians not simply on the basis of how many procedures they perform, and begin at least in part to pay them on the basis of the quality of their work and also the value of what they provide.

I would like to see the entire system begin to be a system of competition based on value, which requires that we begin to measure quality and have costs that can be compared.

The new head of CBO called it a health sector. I think that is absolutely right. We do not have a health care system. What we have is a large sector, and we need a more systemic way of connecting all of it together and paying physicians properly as part of that.

Chairman CONRAD. Let me just say that the statute, the existence of a statute, requires CBO to score a budget in the way you have described. It does not require the Administration to write a budget that way. The Administration has an assumption here that I think is just totally unrealistic, that they are going to save $250 billion by cutting doctors 10 percent.

So let me just say that when I look at this budget, I do not think it is realistic with respect to how it is going to treat physicians. And that savings, which is needed to make the President's budget balance, is not real.

Let me go to health IT if I can, just quickly. My time is rapidly fleeting.

You have a number of major projects underway with respect to information technology. Can you give us a brief update on where we are with those major projects and when we might expect to see results in that area?

Secretary LEAVITT. Mr. Chairman, the most important project, in my assessment, is the development of standards for health information technology systems. We have formed a national collaborative group called the American Health Information Community. We have laid out the most important standards that need to be established and created a means now of making progress in that area.

I can report to you that we are making very serious progress. We have also created a way of certifying systems so that we know they are on a pathway to interoperability.

I met with a young physician who was just going into practice in Tennessee. He said, “I like health IT. I want to buy a system. I just have a question, which system should I buy? I can only afford to do this one time.”

He was asking the question that doctors all over the country have been asking, “which system do I buy to know that I am able to achieve interoperability?” I now have an answer to that, and it is that you buy a system that is CCHIT, which is the Certification Commission on Health Information Technology. If it has been certified by the time, you are on a pathway to interoperability.

I believe that we now have nearly 40 vendors who are receiving this CCHIT certification and more applying. The standards are becoming more robust. I think that we will begin to see interoperability pick up steam and we will also now begin to see more adoption of health IT systems.

Chairman CONRAD. We will have a chance for further discussion on that. My time has expired.

Senator GREGG.

Senator GREGG. I am glad you brought that issue because I have something called the Medicare Quality Enhancement Act, which does exactly that, and which we had hoped to get through last year and we hope to get it through this year. I would just highlight it.

Talk a little bit, if you will, about your proposal on Medicare. I have three issues. Let me write them down because by the time you finish you will have used up all my time.

Tell us a little bit about the Medicare proposal and why it does not affect the low income and middle income beneficiary, but is directed at basically getting a fair reimbursement to providers and also high income individuals.

Second, if you could talk a little bit about a proposal that has passed the House, which would authorize you to negotiate drug prices, which would require you, I believe, to have a formulary—although it says you cannot have a formulary but you cannot really negotiate without a formulary—and what the effect of that would be on supply and options for seniors, the fact that seniors would have fewer options, in my humble opinion, if you are going to have that authority effectively.

And third, I would like to get your thoughts on an idea that was put forward by another former secretary and Governor and now senator, Senator Alexander, who was Secretary of Education, of course, and Governor of Tennessee, and has suggested that we do a swap with the States where we take all of the Medicaid and they take all of the education, elementary and secondary school costs and we do a direct swap. The States are winners financially and we both specialize in an area where we can make sense.

Secretary LEAVITT. First, on the Medicare proposal. May I say again that the guideline here is this is weight loss, not amputation. If we were to impose all of these reductions in the growth rate, we would see Medicare continue to grow. It would grow at roughly 5.6 percent into the next 5 years, as it is slated now to be 6.5 percent.

So this is not a reduction. This is not a cut. It is a reduction in the growth rate.

Now we frankly achieve that, in many cases, by looking at the projected growth rate in various services and trimming them back just a little. And if you trim them back just a little in the early years, by the time you are out 5 years or 10 years they are very large savings. I think that begins to make the point that you did earlier, the sooner we deal with this the better.

There is a point in the life of every problem when it is big enough you can see it but small enough you can still do something about it. And while we may be moving beyond that point in Medicare, the sooner we act the better.

You will see proposals similar to the one that we mentioned earlier, where we recognize that there are those who are receiving full subsidies for Medicare, both in the drug benefit and in Part B. It makes very little sense to me for a young family, 28 years old, who do not have health insurance, to be taxed in a way that contributes to their ability not to have it, so that they contribute to a person who is 70 years old, making $250,000 a year to have full coverage. That does not make sense. And this includes that kind of change.

On the second question you asked with respect to Medicare Part D, it has been a resounding success. We have 90 percent of those who are eligible now receiving the benefit. Every independent survey I know says that between 75 percent and 80 percent of the beneficiaries are happy. The cost started out at $37 a month, it is now this year it will be $22. When you ask the actuaries why, they will tell you one word. It is competition. When you give the people the ability to choose and information about the cost and the quality, they will choose those which will drive quality up and costs down, and that is exactly what happened.

There is only one way to negotiate drug prices and it is to negotiate the formulary. You say I am going to take your pill off my plan if you do not reduce the price. If we allow that to be a Government function, we will have fewer choices and less happiness with the plans. It will not do anything to reduce the cost. That is not my estimate. That is the CBO estimate. It is independent actuaries making the same point.

With respect to the third question on the swap, there have been a number of discussions. One would be to have the States take welfare, or long-term care rather, and the States—or the Federal Government take long-term care. I would be open to any of that kind of thinking. We have to do something. Medicaid is not only eating away our economic capacity as a country, it is also starting education in the States. It is also starving many of the other aspects.

At the root of it, however, is what the Chairman said, it is the high cost of health care. I would hope when I have more time that I could talk a little bit about some of the things that I believe need to be done to reduce the escalation of costs.

Senator GREGG. Thank you.

Chairman CONRAD. Senator Feingold.

Senator FEINGOLD. Thanks very much, Chairman Conrad and Senator Gregg, for holding this hearing. Thank you, Secretary Leavitt, for being here. I am glad we are focusing on the Health and Human Services Budget.

But some of the cuts in the budget will directly affect my home State of Wisconsin. There are two health care programs, very important in my State, SeniorCare which is the prescription assistance program for Wisconsin seniors, and BadgerCare, which is Wisconsin's Children's Health Insurance Program. The President's budget appears to cut this as well.

I hope this is not the case. There are 108,000 Wisconsin seniors enrolled in SeniorCare and 64,000 Wisconsinites enrolled in BadgerCare.

These programs, I can tell you because I go to every county every year and hold a town meeting, are effective, popular, and cheaper than private coverage and other alternatives. So I do not think it makes sense to pull support from these programs.

To follow on that, as I mentioned, 108,000 seniors in Wisconsin are enrolled in the State's prescription program known as SeniorCare. Governor Doyle of Wisconsin has a waiver application pending with HHS. Approval of this waiver would allow the program to continue, but the State still has not received a final answer and the current waiver is set to expire in less than 6 months.

Mr. Secretary, are you familiar with Wisconsin's SeniorCare program and this waiver?

Secretary LEAVITT. Yes, I am, Senator.

Senator FEINGOLD. Thank you.

Your budget request appears to assume that the SeniorCare program, Wisconsin Pharmacy Plus demonstration, will lose its Federal funding after fiscal year 2007. Is this the case? And does that signal that HHS will be rejecting the waiver application?

Secretary LEAVITT. That matter is still being deliberated on. I will tell you that I am very familiar with this. I have had many conversations, both in Wisconsin and with Governor Doyle. The SeniorCare waiver was approved at a time when there was no prescription drug benefit. And the issue before HHS will be a question of whether SeniorCare should be continued or not. It is whether or not Federal money will continue to support it.

We supported it before because there was no prescription drug benefit. The issue that will be before us now is should we continue to support it, given the fact that there are several hundred thousand members of the Wisconsin public that are on Part D.

Senator FEINGOLD. I want to check my facts but I believe one waiver was granted after the program was enacted, I believe that is the case.

Secretary LEAVITT. I think we put a waiver into place to help coordinate the integration of Part D and SeniorCare, and we have been working very closely with Governor Doyle to make certain that the coordination was effective.

The issue of whether or not the Federal Government continues to support both plans is a matter that is being deliberated on right now. But we have been very clear with Governor Doyle that we wanted to make Part D work, and he has been very cooperative to make certain that it did.

Senator FEINGOLD. I appreciate the attention that is being paid to it. It is very important to our State. I take it from your briefings you are aware that SeniorCare costs the Federal Government $617 per participant, and the Federal Government spends $1,174 per participant on Medicare Part D.

This program cost the taxpayers less money and I think it is more popular than Medicare Part D. I can tell you that from my knowledge of Wisconsin. It is what the State of Wisconsin wants. It is budget neutral due to savings generated in Medicaid, and is the primary source of prescription coverage for over 100,000 seniors in my State.

I just want to make it clear that if this waiver extension is denied it will, in effect, cost the Federal Government more money while simultaneously dropping seniors from their preferred drug coverage.

I think that is a lose-lose situation. To use your excellent phrase, more like an amputation than weight loss. I think it could be easily remedied if you approved this waiver. So I hope you will seriously consider that.

The budget discourages coverage of childless adults under the State's of Children Health Insurance Program, SCHIP. I am concerned that this will lead to a policy of not covering any adults with program funds.

My State of Wisconsin covers parents of Medicaid and SCHIP children in addition to pregnant women. There is good evidence that family based coverage is better for children and families and there is no other affordable insurance for these adults.

Does the President support States being able to cover these adult populations under SCHIP? And would the Administration support States like Wisconsin continuing coverage of adults with SCHIP funs?

Secretary LEAVITT. We do support continuation of adults who are currently on the program. We will not be supportive of extending coverage to new adult populations. We believe that SCHIP should be focused on its original intent, which is to help lower income children and we are enthusiastic about its reauthorization. But we do have the feelings I have expressed.

Senator FEINGOLD. Secretary, thank you for your testimony and for your attention to these matters.

Chairman CONRAD. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman, and welcome, Mr. Secretary.

I want to followup a little bit on the physician reimbursement. If the Congress does not enact the changes to physician reimbursement that the President recommends, what is the plan? Do you have a plan in place to deal with that?

Secretary LEAVITT. The reduction is a matter of statute and in order to cure the circumstance, it will require a change in the statute. We remain eager to work on that. If we end up with seeing a 10 percent reduction in Medicare, it is clear to me—or reimbursements, it is clear to me that there will be a certain number of physicians who that will affect. And that becomes a big problem for the Secretary of Health and Human Services, given that I have 43 million beneficiaries—including my parents—who depend on them.

Senator ALLARD. Have you talked about getting that statute changed to Members of Congress?

Secretary LEAVITT. There is an ongoing discussion that we are a participant in. We have made clear that we believe that some part of the improvement or change in the formula needs to include payment to physicians and hospitals on the basis of performance or their adherence with good quality procedures. We think that is not only important from a cost standpoint but it will improve the quality, as well.

Senator ALLARD. On the issue of reimbursement, some States seem to get better reimbursements—at least the physicians do not seem to complain as much as in other States. My State is one where physicians are complaining a lot that they are not getting adequate reimbursement.

In fact, I heard from physician whose practice is solely Medicare. When I heard that I could not believe that he is still in business, frankly.

I did go and visit his practice. It is a very austere practice. He does not have a lot of office furniture. He is not located in a high rent area.

He is near the point where he just cannot sustain his practice. He is ready to go out of business. It looks to me like an efficiently run practice, although I do not know what the quality is like. I know that he has more patients than he apparently is able to handle.

What do we do? In Colorado, our physicians are taking fewer Medicare patients.

Now some of those, they can cost shift a little bit and probably do to some degree. But what do you do when somebody like that who strictly specializes in Medicare patients, becomes a primary care physician. Because that is his entire clientele, he is probably very much of an expert in that area.

Secretary LEAVITT. We monitor this very closely for the reasons I just expressed. I will say that we have not yet seen a dramatic reduction in the number of physicians who are receiving Medicare patients. But it is a concern and it is a problem, in my judgment, we have to deal with on a long-term basis.

We continue—

Senator ALLARD. But let me catch you there. The number of physicians that are accepting Medicare patients, what you ought to look at is the number of physicians that are taking on new Medicare patients. I think that would give you a more accurate reflection of what is going on.

I want to move on. There is a Government Performance and Results Act. Are you familiar with that? It measures performance of various programs.

Secretary LEAVITT. I know the function. I did not know it by that name.

Senator ALLARD. The President's program is called PART. There are some 32 programs in the Department of Health and Human Services that are considered non-performing. There are six of them that are characterized as ineffective.

What do you do when you get these recommendations from the Office of Management and Budget?

What do you do with these programs? Some of them, maybe one or two, it is kind of hard for me to tell, might have been some that you talked about. Some of them are popular programs. There is the domestic HIV/AIDS prevention program that is classified as results not demonstrated. I think you mentioned something about doing more on AIDS. I even see that some of those programs that were brought up as perhaps non-performing, you might even still continue to promote.

So my question is what are you doing with these programs?

Secretary LEAVITT. I mentioned earlier in my remarks that one of the criteria I gave those who make the tens of thousands of judgments that go into this budget, that we should pay particular attention to ineffective, under performing programs. If they are not absolutely vital to our mission, then they are reduced in funding or eliminated. You will see that reflected in this budget.

If they are a vital program that simply needs to be improved, then we have gone about the business of remediating them.

Senator ALLARD. Are there any of them that are classified as ineffective that you did completely eliminate?

Secretary LEAVITT. Yes, block grants under the—

Senator ALLARD. I saw that somewhere here.

Secretary LEAVITT. That is one example. A big one.

Senator ALLARD. Yes, it is a big one.

I see my time has expired but when you testify in front of me, expect a question on the performance of the various programs that are under your jurisdiction.

Thank you for your testimony.

Chairman CONRAD. Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman.

Mr. Secretary, I think the Chairman pointed out in the beginning the need to focus on our health care budget. The amount of money we spend as a Nation and our health care performances have us all reason to pause. We are spending a lot of money and we are not getting the results we should.

So I want to talk about one of the cost centers that jumps out at me, and that is prescription drug costs. For medicines that are manufactured at the same location, American consumers pay a lot more than consumers in Mexico and Canada. Why? What is the reason for it?

Why do we pay so much more for drugs than other countries?

Secretary LEAVITT. Senator, I think at the root of that is a trade problem. We need to deal with it as a trade problem.

Our effort at HHS is to assure that the drugs we do have are safe and effective, and we do that through the FDA. The manufacturers of the drugs oftentimes will go to another country, they will be subject to trade negotiations that provide for them to sell it cheaper, I suppose. I do not know the full answer to that.

Senator CARDIN. I took economics in college and learned that market share is an important issue in negotiating price. All of these other countries, including Mexico and Canada, basically negotiate with the strength of a larger market share than we do in the United States because the payers have relatively a small market share of the full cost.

So all the other countries seem to want to organize their market in a more efficient way to negotiate a fairer price. You seem to resist that as a way to deal with the reducing costs in America.

Secretary LEAVITT. No, actually negotiation is a very important part of what we do. Almost all of the prescription drug benefit would be negotiated through PBMs and they negotiate with—people think the United States Government is the largest purchaser or the payer of prescription drugs. That is not true. The PBMs are, in many cases, three of them are substantially larger and they are the ones doing the negotiating.

Senator CARDIN. There is no reason why we could not have the PBMs have a larger share, if we could figure out a way to negotiate on a larger basis.

I heard Senator Gregg and you talk about restricting drugs to our seniors. And yet nearly all of our consumers other than seniors who are buying medicines are doing so through third-party payers that use some form of negotiated formularies. And I do not get a lot of complaints in my office about being denied access to drugs. In fact, when a doctor believes it is essential to use a specific drug, normally the plans provide a process for that.

So trying to scare seniors that organizing the market more efficiently would lead to the rationing of drugs is not helpful to this debate. It is wrong for consumers in America to pay the prices they are paying for drugs. And our health care system cannot afford to continue to make those payments.

We have to figure out a way to get a fair price for medicines. I appreciate your support for us having tougher trade negotiations. I agree with you on that. And I do think we need to talk about the trade policies of America.

But you are the Secretary of Health and I think we should have answers as to how we can bring drug costs down for consumers in this country, including Medicare beneficiaries.

I want to mention one other point before my time expires because I mentioned it last year when you were before the Ways and Means Committee. And that is racial and ethnic disparities in America. I was disappointed last year that it was not a part of your testimony. I am disappointed again this year that you have not specifically mentioned dealing with the disparities in this country.

According to the National Center for Health Statistics, infant mortality rates for African-Americans are double that for whites. If you are an African-American male, you have a one-third higher chance for heart disease than a white man. American Indian women are three times more likely than white women to receive late or no prenatal care. Diabetes is much higher among Mexican-Americans.

And your budget nearly zeroes out health professional training activities, which is a vital program for training minority health care providers.

I just want to focus for a moment on trying to use our budget to reduce these disparities. I would hope that this is a priority of the Administration, and I would hope that it would be included as one of the pillars of programs that we should be considering to reduce disparities among Americans.

Secretary LEAVITT. Senator, just two comments. One, with respect to the negotiation of prescription drugs, I believe that the reason you do not get too many complaints about people not being able to get the drug they want is because they have a choice of plans. And because they have a choice of plans, they can find a formulary that fits their needs and they can do it at the lowest possible price. I think that is why we have had 90 percent or 80 percent of them are happy.

With respect to the—

Senator CARDIN. But they have formularies. All these plans have formularies.

Secretary LEAVITT. They do, and they can choose one that has a formulary that fits their needs. if we had one play, they would not have that capacity.

Senator CARDIN. No one is suggesting one plan. What is being suggested is to negotiate on a larger market share the pricing with the pharmaceutical manufacturers.

Secretary LEAVITT. But that does not work in the construct of our economy. We have a free market economy where people—we do not have the drug stores owned by the Government and being able to act as dispensaries.

Senator CARDIN. I understand that and that is the same way that the private market negotiates prices. If you have a larger share you are going to get a lower price. It is economics 101.

Secretary LEAVITT. I took economics 101 and I agree that that is the way that it works. I believe we are currently seeing the benefits of robust negotiations that are taking place when consumers make those decisions as opposed to the Government, but—

Senator CARDIN. My time has expired.

Secretary LEAVITT. May I just say, Mr. Chairman, on this, we have robust programs on obesity, HIV/AIDS, and prenatal care. And they need to be because inequities exist. The fact that I did not mention it in my opening statement does not mean it does not loom large in my heart.

Chairman CONRAD. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I took economics 101 also, but I did not take it where they had a controlled economy. I took it in a free economy. And the Federal Government did not set prices like they do in Canada. They also had a chance to control the quality of the drugs. And the development is being paid for by the American consumer for almost every other economy in the world, because we are the only ones developing new drugs.

So there is an explanation for difference in Canada, Mexico and the United States.

Discretionary spending at HHS makes up only about 10 percent of your budget, 84 percent of the budget goes to two programs: Medicare and Medicaid. Long-term what does this mean for your agency? How critical is it that we get a handle on the entitlement spending?

Secretary LEAVITT. It is critical not just for my Department. It is critical for the country. We are now measuring Medicare as a percentage of the gross domestic product. It is 3.2 percent of the gross domestic product. By the time my grandson becomes an adult it will be 8 percent of the gross domestic product. By the time he becomes my age, it will be 14 percent of the gross domestic product.

None of us believe that will happen because we will have either been eliminated from the economic competition in this world, or we will have changed the direction of it. The sooner we change the direction of it, the better off we will be.

Senator BUNNING. I will followup on that in just a minute, but one of the things that really hit me between the eyes is a 17 percent reduction in Low Income Home Energy Assistance Program that is in the President's budget. Mr. Secretary, you know and I know that that is not going to happen.

Last year, in the 206th Congress, we put in $1 billion more in emergency spending into that program. My home state of Kentucky received over $45 million in LIHEAP in 2006.

Under your budget, Kentucky would receive only $21 million. Now costs for heat and low income people have not diminished in Kentucky. So what you are proposing is a direct confrontation with me and everybody sitting up here on LIHEAP.

Now you ought to know better. You ought to know better because you know we are not going to allow that to happen. Even though it is one of the programs that consumers, particularly low income consumers, use this program need desperately.

Now we have had a fairly light winter but we are going to have, as we are getting right now, a heavier winter, maybe later, maybe not as big as last year, maybe as good as last year. But that is not a reasonable assumption on the budget of the President of the United States, to make a 17 percent reduction in LIHEAP.

Secretary LEAVITT. I can, at least, offer some explanation. The $1 billion that we added last year was actually by agreement, $1 billion we accelerated from the 2008 budget.

Senator BUNNING. Yes, because we did it in an emergency supplemental program.

Secretary LEAVITT. Everyone at this table or in this room knows that members of the public who do not have heat need to have it and that we are going to meet that obligation. That was done because it was in the 2008 budget—

Senator BUNNING. Do you think somebody is cheating LIHEAP?

Secretary LEAVITT. No.

Senator BUNNING. Do you think consumers are cheating?

Secretary LEAVITT. No, no, no. I did not say that.

Senator BUNNING. The fact of the matter is that there is a huge need out there.

I want to get back, I am almost out of time, concerned about entitlement growth, particularly in Medicaid and Medicare. The budget slows the rate of growth, as you said in your opening statement, from 6.5 to 5.6 over 5 years. In Medicaid the growth rate from 7.3 to 7.1.

Our-year, 75 years out, it saves $8 trillion, $8 trillion. That is not going to be enough to save the program but we better make the start. And we have to have a reasonableness about these two programs or we are not going to have any programs, as the chairman has said, in 2045 or 2050, depending on who is doing the addition and subtraction.

So please stick to your guns on this, because we have to have this if we are going to have a program for my 35 grandkids and my four great grandkids. They are not going to have a program.

Secretary LEAVITT. It is our budget and we are sticking with it.

Senator BUNNING. It is going to take some negotiations to stick with it, but I hope you do.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Mr. Secretary, welcome.

Mr. Secretary, can you tell me, do you believe the SCHIP program has proven to be effective in covering children and families?

Secretary LEAVITT. It has.

Senator MENENDEZ. I am glad to hear that. In New Jersey we are successfully covering over half a million children under SCHIP. But I am concerned that the President's budget request undermines the future of that ability to do so.

So I have heard you say in other hearings that you do not believe that children will be dropped from the program under the President's budget proposal. Is that still your belief?

Secretary LEAVITT. That is our belief.

Senator MENENDEZ. Are you going to be guaranteeing the States will be reimbursed for children's coverage at their current rate?

Secretary LEAVITT. It is our position that children who are currently covered need, under the construct of reauthorization, to continue as well as adults. We do, however, believe that in the future we should focus SCHIP on the core mission which is children. And we do not support the addition of additional adults. And we believe that children who are in excess of 200 percent of the poverty line should be matched at the normal Medicaid match rate, as opposed to the enhanced match rate.

Senator MENENDEZ. So as I hear your answer, because I am concerned that instead of weight loss we have a gastric bypass here, that, in fact, all of those who are presently covered, children and adults, it would be the Administration's position that the rate of reimbursement would be the same as that which they presently are enjoying. Is that what I understand you to say?

Secretary LEAVITT. I want to confer with my colleague.

Senator as I have expressed, our position is on anything in excess of 200 percent of the Federal poverty line we would support continuation of coverage, but only at the normal match rate, not the enhanced match rate.

Senator MENENDEZ. So that means, in fact, if a State—for argument's sake—had 225 percent of coverage and you are presently covering them at the enhanced rate, then you would drop back down by, in that example, 25 percent.

Secretary LEAVITT. We would continue to support it at the normal rate but not at the enhanced match rate.

Now, I would add that we feel strongly that our objective ought to be to have a basic affordable plan available to every American and that SCHIP is a very important part of that and that we should be working with States to integrate what they are doing with SCHIP into their other efforts.

We do not see SCHIP as the vehicle to cover all Americans, but we do think it is important component of—

Senator MENENDEZ. I appreciate that. But the bottom line is that you cannot quite make the statement then that those children and adults presently covered under State programs, like New Jersey's program, will continue to receive the current rate of assistance from the Federal Government because if that rate is beyond the 200 percent then you will not fund it beyond that.

That means that, in fact, States would either have to make a decision to cover it themselves out of their own resources or drop those individuals who do not qualify above 200 percent.

Secretary LEAVITT. They would remain eligible for the program but we would standardize our reimbursement in the way that you have acknowledged. That does not mean they would be dropped from coverage. It does mean that in our partnership with the State they would be required, on those efforts that are above 200 percent, to offer more support or to find a different way to cover them.

And we think there are many. I have been working with Governor Corzine to look at ways that we could offer a basic affordable policy to every citizen of New Jersey.

Senator MENENDEZ. Well, I appreciate that. But the bottom line is that, in essence, to me, this means that there are States who are clearly going to receive cuts. We can dance around how we describe it. But the bottom line is if there is a present rate of reimbursement and that is no longer to be held, that means the States will receive a cut and they will have to make choices as to whether or not they can cover someone and how they do so.

And that is different than when I see the President get up at the State of the Union and talk about enhanced coverage. I just do not see enhanced coverage in this process. I see a diminution of coverage to some of the individuals who are among the most neediest in our society and the most vulnerable in our society.

So I appreciate the President's suggestion of a program of a tax deduction. The only problem with that is, first of all, that flexibility has already existed by waiver. And second, it is only good if you have the money in the first place to dish out to buy health insurance.

In a high cost State like New Jersey, in the family incomes that I am talking about, which exceed 200 percent but certainly not put them anywhere near the ability to do that, it is meaningless.

Secretary LEAVITT. Well, the President has made clear that we should be willing to contribute Federal resources to assure everyone has a basic affordable plan. We do not view SCHIP as the logical vehicle to extend that coverage to every resident of the State of New Jersey or any other State. We think it ought to focus on its core mission, which is children.

Senator MENENDEZ. I have no doubt that—I am not suggesting that this is a vehicle to create universal coverage. What I am suggesting is that the Federal Government should at least keep its obligation to that which has—to those which are presently enjoying the benefit of the coverage and for which the Federal Government made a determination to be supportive of the enhanced rate. Absence of that means a cut and a cut ultimately means decisions as to whether you keep children and certain parents on or whether you release them.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator CORNYN.

Senator CORNYN. Thank you, Mr. Chairman.

Mr. Secretary, thank you for your service and for being here today.

Last year 19 senators, including eight on this committee, sent you a letter urging you to make diabetes screening in the Medicare population a priority in the budget. As you know, more than 61 percent of the Medicare population has either diabetes or prediabetes, and most of those with prediabetes are undiagnosed, almost 14 million people.

When you combine this number with the fact that NIH's diabetes prevention project proved that people age 60 and older could reduce their rate of diabetes and its complications by a staggering 71 percent, it is clear that we could save money and lives by identifying those seniors and helping avoid diabetes and its devastating complications, including blindness, amputation, and kidney failure.

Could you tell me whether your new budget responds to the concerns that were raised in this letter last year about diabetes screening?

Secretary LEAVITT. It does in several ways, Senator. One that I point to that I believe is perhaps the most important is the effort to assure that we are beginning to measure quality in practice. One of the most important quality measures, for example, in a practice would be the testing of hemoglobin A1c among those who have diabetes and testing for diabetes generally among the larger population.

We are proposing, in our efforts, that as physicians are able to meet those quality measures that the costs will be improved and lives will be saved. Rather than just spending more money to test, we want to hold the testing as a standard of practice so that we discover it early and save the money and the lives that are accomplished by that.

Senator CORNYN. When I went out to the NIH last and talked about the challenges they face and the opportunities that they see, they mentioned to me that—and I believe this was confirmed also by the American Diabetes Association—that about $134 billion in avoidable costs could be saved if we did a better job of preventing diabetes which, as you know, is largely preventable in its most common form by improved diet and exercise.

What can we do to provide the financial incentives to the health care community to focus on prevention and obviously save a lot of money and avoid a lot of human misery?

Secretary LEAVITT. I mentioned earlier in our conversation today here in the committee that health care costs are primarily a function not just of efficiency in the system but also prevention. We make prevention, if we pursue it as tenaciously as treatment after we are sick, we will start to see reductions in dollars. But we will also see a lot of lives saved.

I will tell you that we are currently spending about $600-plus million a year on the subject of obesity, how can we begin to change the patterns of Americans that are producing the tens of millions of people who suffer from diabetes? It will be obesity and the inherent diseases that result have to be considered among our most significant health threats in this country.

Senator CORNYN. Is there something we can do in terms of health care provider payments, to provide them the financial incentive to do the early intervention and prevention? I appreciate your comment earlier about calling it the health care sector rather than a health care system, because we do not really have a functional system. And some have observed we actually have a sick care system, not a health care system.

So are there financial incentives that we can create to give providers the incentive to actually act to intervene before people become ill?

Secretary LEAVITT. I look forward to the day when we have electronic health records that will allow us to measure how many patients have proper preventative measures taken by physicians and by health care providers at various stages that will result in fewer cases of diabetes. And we can reward physicians for having done that.

Now physicians do not control everything their patients do but they can control what they do when they come in and whether they talk with them and counsel them and whether they are doing the kinds of things that could begin to drive those down.

Senator CORNYN. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Cornyn.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Welcome, Secretary Leavitt.

Secretary LEAVITT. Thank you, Senator.

Senator WHITEHOUSE. I would even go so far as to say we do not just have health care system, we do not even have a health care sector. We have a health care mess and we really need to straighten it out. It is very, very urgent.

In the context of that, I just want to react to some things you said. We had testimony in this room not long ago that the cost of the Part D program to American taxers looking forward was $8 trillion. We have seen reports just out recently that the difference between the cost that the drug companies get through Part D versus what they get through the United States Government Veterans program is as much as 58 percent. If you take the 100 percent cost and add the 58 percent, it is about one-third extra.

If the $8 trillion is right, that is $2 trillion over the life of this program. By any standard that is big money. And the idea that we are not going to pursue that just astounds me.

It is not a formulary. I just want to make it clear to anybody who is watching what the expectation would be here. It would be that you would be the power to negotiate, the one that your predecessor, Governor Thompson said was the biggest thing that he missed in that position. And that with that power to negotiate, you could bring together the different providers so that through their existing formularies the same drugs that there are in, you could negotiate collectively to bring the price down.

And ideally, I would like to see you have a competing program of your own which would add to the choice of seniors. So when people come in here and say well, it is a formulary or it takes away choice, that is just nonsense. That is just not true, not I think if you try to understand where people who are pushing for this are coming from.

I think you can be effective if you picked the top 10 or the top 20 drugs and get the providers together and negotiate with the pharmaceutical industry to the prices that they are already paying the VA. I do not know what the exact number is but it is a big, big number. And it is extraordinarily frustrating to have us be stonewalled when we are having these discussions about how much money we need to save and we are talking about cutting things like SCHIP, to have the Administration unwilling to pursue what seems to me to be obvious.

I would love to work with you more on that but I really think that you are just talking past me when you say these things and you are not even talking realistically from where I am coming from. So maybe off-line we should have a further conversation, if you are interested. But I just do not get it.

The other place where I just do not get it is with health information technology. You said it was the most important thing that we are working on, that you have a very serious program. The RAND Corporation says that we could save either $81 billion a year with adequate investment in health information technology, that is their lowball bid or estimate, $162 billion a year was the mid-line number. By comparison to other industries, they said it could be $345 billion a year.

If you take the lowest number, the $81 billion a year, I calculate that—maybe my math is no good. I did not take economics 101. But my arithmetic is that that is $221 million a day in savings from adequate health information technology in our health care system.

Your entire on-CHIP budget is $118 million, less than 1 day's savings. Mr. Braylor is gone for months. There is no replacement.

I appreciate the energy of your words on this subject but I would like to see appointments and budget money that gets behind the need that we have. Because I agree with you. I think that health information infrastructure is the key to colossal savings in the system.

And we in this room are going to have a tragic choice coming up between cutting benefits or raising taxes if we do not get under why this health care mess is broken. And we need that information technology to make it happen.

And I urge you to consider real investment in this, and really getting behind it, not the kind of investment where you could get it back in 1 day of the projected savings.

Secretary LEAVITT. Senator, there are hundreds of millions, billions of dollars being invested right now in health information technology throughout our economy. The proper function of the Federal Government is to assure that they are operating on standards that will allow them to interconnect. We are making dramatic and rapid progress toward that.

Senator WHITEHOUSE. In Rhode Island, the leading edge of health information technology is a group of private physicians—

Secretary LEAVITT. My point exactly.

Senator WHITEHOUSE [continuing]. Who got so frustrated with this that they are trying to develop an electronic health record on their own.

Secretary LEAVITT. Senator, they joined—

Senator WHITEHOUSE. I have to tell you—

Secretary LEAVITT. They join 200 other vendors who are offering health information technology. And if they do not connect, they have value in their practice but they do not create a system of health information technology.

With respect to the matter of the drug benefit, may I just say our time is up but I completely disagree with your characterization. Do not take my word for it. Take the word of CBO or for independent actuaries who make very clear that there would be zero savings if the Government were negotiating. And what you would have are a lot of unhappy beneficiaries because they would not be able to get the medications that they seek.

They are currently able to do it because they can choose a plan with a formulary. We are saving money, a lot of it, and people are happy.

And by the way, former Secretary, former Governor Thompson, indicated that he sees the program working and sees no reason to change it.

Senator WHITEHOUSE. I am out of time, Mr. Chairman.

Chairman CONRAD. We will have another round.

Senator NELSON.

Senator NELSON. Good morning, Mr. Secretary.

Secretary LEAVITT. Good morning, Senator.

Senator NELSON. Mr. Secretary you have covered a lot of different questions here. I want to get on one that you have not covered and it is a particular matter that we have a lot of unfortunate experience in my State of Florida, in the confiscation of senior citizens' prescription drugs when they order them from Canada.

We have been through this for several years and naturally your Department has an interest in seeing that the drugs are safe. And the Acting Administrator before you became Secretary, the Acting Administrator of the Food and Drug Administration, assured me that what the FDA was looking at was trying to get at the people who are gaming the system with counterfeit drugs and so forth, that the individual citizen that is ordering by mail or by the Internet or by telephone for a limited supply for personal use—and that FDA Administrator defined a limited time a 90-day or less supply—that it was the position of FDA that they were not going to try to confiscate those drugs.

So we rocked along and we have had an up-and-down on this. But finally last October, Customs Department threw up its hands and said we are not going to confiscate these drugs anymore.

I thought that was the end of it. But what has happened just in the last month is that at least just in my State, just in South Florida, 37 packages of medicine shipped to South Florida for senior citizens was confiscated.

Now Senator Vitter and I thought that we had taken care of this problem on one of the appropriations bills last year by putting an amendment on that said that if the drugs were from Canada and it was for limited supply and it was for personal use that that was going to be legal. But you know the trouble that we got into with 11 of the 13 appropriations bills. When they went to conference they never passed it and that is what we are dealing with where I have just come from the floor right now with an emergency continuing resolution to keep funding the Government in those 11 departments that were not funded.

So that amendment that we put on is not the law, and yet customs said it was not going to confiscate, but here we go again. Now confiscations are occurring.

So I need some direction from you.

Secretary LEAVITT. Senator, I am not able to respond with respect to the Customs. Our role at FDA is typically to test and to determine the efficacy and legitimacy of drugs that are presented to us by the Customs, Immigration and Customs. The specifics of the 37, I am not able to respond to. I can tell you there has been no change in policy during that period. And so perhaps we ought to pursue the specifics of those proposals off-line.

Senator NELSON. OK. Let me just give to you the commentary for additional elucidation. On a Friday in early February, a Food and Drug Administration spokeswoman said that the Canadian pharmacy shipments were detained at the Miami International Airport for routine reasons.

And so we have—what I am afraid is we have one hand that does not know what the other hand is doing. And I would appreciate it if you would get in. Now, of course, you and I know that this does not solve the problem. What solves the problem is a lot of these other issues that have been discussed here today with regard to the cost of medicine.

But it is, for some of our seniors who are having difficulty in making financial ends meet, it is a lifeline to help them be able to afford their drugs and also to afford groceries to eat. Because in most of these cases they are getting these drugs from Canada at half the price that they would pay in a pharmacy in the United States.

So if you would like to do this off-line, I would appreciate it if you would then respond in writing so that we can get to the bottom of this and solve a problem that otherwise should not be a problem.

Secretary LEAVITT. Can you supply me with the specifics of this situation? Because I do not know them and I would be happy to respond to that specific.

I know that the time is up, this has been an ongoing problem and one we are all trying to solve. It does not eliminate, however, the potential for unsafe drugs under the banner of the Canadian flag coming into this country in a way that is hurtful, harmful, and dangerous to people. Counterfeit drug making is a big industry and it is a worry to me.

Senator NELSON. Well, I understand that. And of course, that is the reason that Customs and FDA have given in the past. But you all have to worry about people really taking advantage of the system and getting in big quantities of these things where they can then be resold and who knows what is in them because they are counterfeit and so forth.

But the likelihood of that occurring from a Canadian pharmacy for an individual prescription prescribed by an individual doctor for an individual person for a supply of 3 months or less, that likelihood is de minimis compared to what you are looking at.

And when you balance that against the financial need of the seniors until we can get the overall cost of these drugs down, it is—

you have to make choices. And this is the choice. And the Senate has made this choice, and so has the House. But for the appropriations bill not passing we would have this etched into law.

And I thought we had solved our problem but we have not, now that we are seeing these additional confiscations, Mr. Chairman.

Mr. Chairman, I know you want to close. I will just say this, that really what we ought to do is go on and passed the bill that you filed and I have cosponsored, which will etch this thing in law. And then I will not have to go around and try to amend it on appropriations bills.

Chairman CONRAD. I thank the Senator.

Secretary Leavitt, I have a couple more questions and I think Senator Whitehouse would like another round as well.

On your means testing proposal, I want to understand this better if I can. First of all, I have stated publicly and I have said here today, I support a means testing or income relating, whatever one wants to call it these days. I think it is going to be essential to dealing with the long-term imbalances that we confront. We are going to have to make tough choices. I am thoroughly prepared to make that as one.

But when I look at your proposal, the proposal that is in this budget, it is not indexed. And so the question comes to mind what happens over time as you have a means testing not indexed?

It seems to me unavoidable that you would have more and more people who would be forced out of Medicare or choose not to participate, especially as this goes on for an extended period of time. Have you done any analysis of the 10-year effect, the 15-year effect and beyond? How many people would choose not to participate or be forced out of Medicare because your plan is not indexed?

Secretary LEAVITT. Analysis has been made, only a small percentage of all eligible Part D beneficiaries would be paying higher premiums, 2.7 percent in 2008, and just 4.7 percent would be paying in 2017.

We do not believe that it would ultimately force people out of Medicare. For the most part, people find Medicare a very helpful service because—

Chairman CONRAD. But I am talking now further out. If you have a limit here, an income test, and again I support the basic notion. But when you do not indexed it over an extended period of time it starts small. But they are talking here about $8 trillion of savings from your various proposals—and this is one of the biggest ones. I assume substantial part of that $8 trillion is from this proposal.

Over 20 years, 25 years, the percentage has to increase dramatically.

Secretary LEAVITT. It removes any indexing so, as you say, it is not indexed—or indexes it rather, so that it does go up over time.

Chairman CONRAD. It is indexed?

Secretary LEAVITT. It is not indexed.

Chairman CONRAD. Well, that is my point. If it is not indexed, then it over an extended period of time many more people have to be affected.

Secretary LEAVITT. You asked if we had done analysis. We have. It would affect 2.7 percent in 2008 and it would affect 4.7 percent in 2017.

Chairman CONRAD. Many people is that?

Secretary LEAVITT. Two million.

Chairman CONRAD. Two million by 2017. But beyond that, what are we talking about—

Secretary LEAVITT. That is Part D I am talking about.

Chairman CONRAD. Part D.

I am talking about all of the parts because this is a proposal that just does not affect Part D. This affects Part D. This affects, as I understand it, all of the elements.

So how many people would we be talking about—and again I am not talking about just the 10-year effect. Because if it is not indexed as you go out to 2025 and 2035, this thing must have an effect on millions of people.

Secretary LEAVITT. The information I have just been presented indicates that beneficiaries paying the higher premium in 2017 under Part B would be 9.5 percent that would be affected. Again, the principle is the same.

Chairman CONRAD. But how many people would leave? How many people would choose not to participate?

Secretary LEAVITT. I do not have information that would reach that conclusion. I think you could draw conclusions recognizing that there will be some who will, as they get into higher incomes, will have greater income to pay. The principle is the same, Senator.

Chairman CONRAD. Hasn't the CMS Actuary given you an estimate?

Secretary LEAVITT. If they have, I do not have it with me today.

Chairman CONRAD. Let me tell you, the estimate that I have from CMS, which is your agency, is that by 2017 43,000 people would leave Medicare. That is just Part B. That is just Part B.

That is the near-term effect. What I am concerned about is if you do not index, when people up here are talking about $8 trillion in savings, we have to understand what that assumption means.

So I am going to ask you today, I would like to have CMS give us their estimates of how many people would be affected, how many people would leave Medicare or, in essence be forced out, because it is not indexed.

We have to understand before we pursue this, and let me just reiterate I am for the basic notion. I think it has to be part of the solution. But I do not want to have something that winds up excluding tens of millions of people because it is not indexed. And when you get out 40 years all of a sudden you have excluded 10 million people.

Secretary LEAVITT. That will be helpful information and we will be happy to provide it.

Chairman CONRAD. I think we need to know that.

SCHIP, our staff estimates are that it takes $15 billion to maintain the SCHIP program as is and that this budget only provides $5.6 billion. So that the basic SCHIP program that is available now is significantly underfunded, and could not be maintained under this budget.

Do you have estimates of how many children would be excluded from SCHIP as a result of this budget, in comparison to the budget required to maintain the SCHIP program as it exists?

Secretary LEAVITT. Senator, I have articulated the position of the Administration as clearly as I can. It is our belief that the budget proposal we have put forward would allow that policy to be implemented. The actuarial figures I do not have today. Obviously, as the conversation goes forward we would be happy to provide whatever backup we can.

Chairman CONRAD. I have a very specific question. And that is with this budget, in comparison to a budget that would maintain the SCHIP program as it currently is, how many children would be excluded from coverage?

Because we have roughly 4 million children, as I understand it, covered. As we look at these numbers that are in the budget, there is no way to maintain the program as it is for those people.

A final question I would like to go to, and I thank my colleague for his patients, is the question of fraud. A number of years ago we had a series of hearings on fraud in the Medicare program and I tell you it was truly outrageous.

We found in wound kids, for example, wound kits, there was a scam going on around the country—in fact, I held a hearing in North Dakota and we had several providers stand up and say they had been presented with this scam operation which was to cheat Medicare by getting wound kits that normally, as I would recall, cost $8. And they would basically defraud Medicare by charging three times as much to Medicare than what the things really cost.

It was a scam that involved some operations on the East Coast and then they were being aided and abetted by people who delivered the service around the country who were invited to share in the fraudulent returns. And so they set up a giant network.

Now you mentioned at the beginning of your testimony and in our conversation, and I do not want you to go into things that would in any way jeopardize your ongoing investigation. But can you give this committee insight, to the extent you can, on what you are finding with respect to fraud?

Secretary LEAVITT. Senator, I indicated to you that I had recently participated in activities of the Office of Inspector General where we have actually gone out and begun to inspect the compliance of various durable medical equipment providers in certain communities around the country.

I will confess to you that it was one of the most disheartening experiences of my public service career. We walked up to a strip mall in a particular area. There are 21 different criteria than a provider has to give if they are to be given a number and be able to do business. Those things include you have to have a place of business, you have to be able to demonstrate you have a supply of medical equipment, you have to have your name posted prominently and a telephone number.

And so we would walk up to these strip mall places and rattle the door during the middle of the day and there was no one there. And you would look inside and there would be three chairs and a little supply of medical equipment. And then you would see the name—that had met the requirements of the number but there was clearly no business going on there. And when you would go back and check against it you would find that there were hundreds of thousands, often millions of dollars, billed against that number.

I then went to an office building of about 20,000 square feet, two stories. There are four rows on the marquee of businesses, probably 70 or 80 businesses in this building. I would guess three-fourths of them were durable medical equipment suppliers.

Chairman CONRAD. In one building?

Secretary LEAVITT. In one building. I walked up and down the aisles and it was like a dormitory. On each side you would see doors. When you would knock on the door there would be no one there. When you would finally get somebody to open it, it would be a woman who would have children and generally they would not speak English. It was very clear that this was a building full of businesses that were front operations.

Chairman CONRAD. Front operations.

Secretary LEAVITT. In the particular city where I was on that day, the agents told me that there were four such buildings. We inspected several hundred different providers and found that nearly half of the number were fronts. And we are proceeding to cancel and we are working with all of our resources to convict and to ferret this out.

Chairman CONRAD. Do you have any estimate, Mr. Secretary, on what the losses might be from these kinds of operations?

Secretary LEAVITT. We are working, at this point, to try to establish that. It is very clear that in a program that you are going to have some losses. But it is at a rate that is untenable and unacceptable.

Our budget includes $183 million which we believe to be essential to be able to beef up our enforcement activities. It is clear to me, Mr. Chairman, that the payback return on that investment is multiple.

Chairman CONRAD. Mr. Secretary, for the purposes of this committee, if you could provide us—given you have to submit a budget long ago. We understand that. You have new information here.

If you could give us some idea of what additional resources are necessary to pursue these scams. I think the message needs to be loud and clear. If you are engaged in this kind of scam, we are coming after you and you are going to regret that you ever entered into this kind of fraudulent enterprise. The Federal Government is coming after you and we are going to have the full resources to put you in jail and get full restitution. And this will be—you will regret you ever went down that road.

Secretary LEAVITT. Mr. Chairman, we will provide it and we appreciate your interest in it.

Chairman CONRAD. We thank you.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thanks, Mr. Chairman.

It sounds like your building in the Cayman Islands that we had featured in an earlier hearing.

As our time ran out, Mr. Secretary, you mentioned a CBO report that suggested that negotiating by Federal Government would not save any money for taxpayers or for the system. I am aware of one conclusion that was drawn by CBO, which is that passing the statute that withdrew the bar or on your negotiations would not save any money. I have talked to CBO about that and I just want to make sure you are aware of why they decided that.

They decided that because all that would do would be to take away a restriction on you doing what Director Thompson said was the most important power that he did not have as Director. But it would not guarantee that you would.

And because they have to kind of read the future and prognosticate, because there was the prospect of the Department of Health and Human Services would simply sit on its hands and not negotiate or do so halfheartedly or not be effective in the way it went about doing it, they could not tell where it would fall and they could not provide a number.

But you should not believe that the CBO does not think that there are significant opportunities for savings for American taxpayers from getting the Government involved in these negotiations. They just cannot identify them because they do not know what you are going to do about it yet.

Secretary LEAVITT. Well, then let us talk about the independent actuaries who drew the same conclusion, or let us begin to look at the—

Senator WHITEHOUSE. Would you send me that because I do not have those. I would love to continue this debate because I think is vital. I mean, $8 trillion, sir, is $27,000 per American. And most Americans—a lot of Americans do not pay taxes. So for people who are watching this, and are actually tax paying Americans, they are looking at a good deal more than $27,000 skin in the game on this.

And if, as reports that we have seen from independent folks are saying, there is a 50 percent extra premium being paid to the pharmaceutical industry because we will not negotiate, that is trillions and trillions of dollars and we, I think, have to have a really honest discussion about that and understand exactly what the CBO said in its report. And I am happy to followup with you and look at these other things.

But please do not count the CBO as having said no, no, no, negotiate will not save money. All they said is that just by changing the statute they could not tell whether you would actually do anything under it and so they could not put a number on it.

Secretary LEAVITT. Senator, I am prepared to remain open-minded on that point if you would remain open on the point that there is no way that there are trillions of dollars that can be saved over an efficient marketplace. You have—

Senator WHITEHOUSE. What makes you think this is an efficient marketplace?

Secretary LEAVITT. Because you have the largest payers in the business competing. And when they compete, they very clearly say if I do not have the lowest possible price, then there is no way for me to keep the business of 38 million people.

Senator WHITEHOUSE. We are going to disagree about that because I think the fundamental problem is that we have market failure in the health care system. And until we straighten it out, the marketplace effects are muted and dissolved and we do not really take advantage of it.

Secretary LEAVITT. We will agree on the point that we did not have a system of competition in health care, generally. But one of the best examples we have where competition has been injected and where it has worked has been in the Medicare Part D. It is indisputable that the actuarial estimates started at $37. And this year they will pay $22. And the actuaries very clearly indicate that that is because of competition.

And with the number of plans we have if there is anyone who has the capacity to deliver a drug program at a dime cheaper, they are going to get a lot of business. And they will.

Senator WHITEHOUSE. And I think if the Federal Government got involved, it would drive it down even further.

Secretary LEAVITT. I do not think there is evidence on that, but we will—

Senator WHITEHOUSE. A separate point. On the reduction to Medicare doctors of 10 percent, in addition to what Chairman Conrad suggested, which is that is probably not going to happen in this building, I would suggest to you that if you tried to implement it, even if we put it through, it would not affect 10 percent savings across the board anyway. Because there is such an elaborate system out there for fighting back and forth over claims payment, and so many different ways that providers can reconfigure their claims filing methodology, that an enormous amount of that goes out the door. And a lot of it that does not go out the door gets lost in patient care to the people who this is designed to do.

So I think is a very, very effective and inefficient way to try to pursue savings in the system. But I have never seen a good number for how much you think that costs, the battle between the insurance industry on the one hand with all of its utilization review technology, and the providers on the other side. I am drilled into this reasonably far in Rhode Island, sir, and I want you to know that the doctors in Rhode Island, they are involved so heavily in trying to fight for payment, in many cases 50 percent of their staff is doing nothing but fighting for payment. We have trench warfare over payment in the health care system and it produces, by my lights, not a dime of health care value.

So to me the trick is how do you dissolve that trench warfare? How do you get clarity as to what should be paid for and what should not, rather than putting more pressure into the trench warfare by saying OK, across the board 10 percent reduction?

I just think it backfires. I do not think it is a good strategy.

Secretary LEAVITT. Listen, Senator, I think the way we reimburse health care is a witch's brew that no one understands. I think that it is saturated with inefficiency and that it clearly, over time, should be replaced with a system of competition based on value. Where we have a system of electronic health records that connects us into a system where consumers can have an independent assessment of the quality that they are receiving, where they can have care that is provided to them in episodes of care where the price is understandable, and where the incentives for everyone is to drive the costs down and the quality up.

We are pursuing all of those policies aggressively. And I would love to spend some time talking with you about the way I view this system. Because it sounds to me as though we could reach agreement on the fact that the system we currently have does not work well and that we ought to be migrating toward—

Senator WHITEHOUSE. That is the understatement of the day.

Secretary LEAVITT. I want to underscore it and make it the quote of the day.

Senator WHITEHOUSE. I appreciate it and I do look forward to working with you. I think this is urgent. I think we are late. I think it is scandalous how we have allowed the system to develop to this point.

And the fact that we, in this building, are going to start to have to look at benefit cuts for people who are at the very most difficult part of their lives, seniors, people just making it economically, that we are going to have to look at giving them a hit because we have not done our jobs in supervising and administering and creating a system that cleans itself and that does these things right.

I mean, it is just an absolute disgrace. And I really want to work as hard as I can with you to solve that problem.

Secretary LEAVITT. Good.

Chairman CONRAD. I thank the Senator. Let me just say I have asked Senator Whitehouse, because of his very strong background in this area, he was put in charge of a very serious problem in the State of Rhode Island that required immediate action, and he did a remarkable job there on these issues.

And so he has a very significant expertise that this committee is drawing on. I have asked he and Senator Wyden and Senator Stabenow to lead a subpanel of this committee to focus on health care and the opportunities that we have to rein in these costs and to provide better health care outcomes. So I thank Senator Whitehouse for his attention to this.

And I thank you, Mr. Secretary. Thank you for coming before the committee. We thank you for your service. You know, we have disagreements, we have debates. That is what the system is about. That is how we get at the truth. But I think all of us know you are an outstanding public servant and we very much appreciate your service.

Secretary LEAVITT. Thank you, Senator.

Chairman CONRAD. Thank you.

[Whereupon, at 11:49 a.m., the committee was adjourned.]

PREPARED STATEMENTS

Russ Feingold

Statement for the Record
From Senator Russell D. Feingold
For the Hearing on the HHS FY08 Budget Requests
February 13, 2007
Senate Budget Committee

Opening Statement

I thank the Chairman and Senator Gregg for holding this hearing today. I would also like to thank Secretary Leavitt for being here. I am pleased that the committee is focusing on the Health and Human Services budget, and today I look forward to hearing explanations about the budget request for the Centers for Medicare and Medicaid Services. This agency's budget has a profound effect not only on those enrolled in public health programs, but also on providers and individuals enrolled in private health insurance. I am particularly interested in how this budget will affect the health care system in my state of Wisconsin. This hearing provides a chance to look more closely at the numbers requested by the administration, and to better understand the President's goals.

Like many other Americans and members of Congress, I am concerned about the budget cuts proposed for Health and Human Services. At a time of rising poverty levels and rising health care costs, this budget proposes cuts of roughly $100 billion in health careto programs. that address these problems.

This budget is bad for those enrolled in Medicare, Medicaid, and SCHIP. It is also a disservice to American taxpayers and those who have private health insurance, who will end up footing a more expensive bill as the numbers of uninsured and underinsured increase. The cost of medical care for a sicker population will undoubtedly fall onto businesses and privately insured individuals just as it has in past years. This is an expensive and inefficient way to pay for health care. We need to be making people healthier, covering the uninsured, and reforming coverage in the U.S. health care system.

This is the only long-term answer to our growing health care crisis.

Some of these inefficient cuts in the budget directly affect my home state of Wisconsin. There are two health care programs very important to my state—SeniorCare, the prescription assistance program for Wisconsin seniors, and BadgerCare, Wisconsin's Children's Health Insurance Program—that the President's budget appears to cut. There are 108,000 Wisconsin seniors enrolled in SeniorCare and 64,000 Wisconsinites enrolled in BadgerCare. The programs are effective, popular and cheaper than private coverage. It doesn't make sense to pull support from these programs. I look forward to hearing an explanation of why the President's budget apparently proposes to do that.

We can and should do better for the many Americans who depend on the programs in the Department of Health and Human Services. This proposed budget will result in families losing essential health services that provide assistance for people in need. and that is . I look forward to working with my colleagues to come up with a fiscally responsible budget that also helps those in most need of a helping hand.

Statement for Senator Bunning
Budget Committee Hearing
HHS Budget
February 13, 2007

Mr. Chairman. Thank you for holding this important hearing today.

I also want to thank Secretary Leavitt for being here today. The Secretary runs one of the largest departments, and oversees some of our most important programs – healthcare for the elderly and children, research into diseases, and certifying the safety of our drugs and food.

The President recently released his budget for fiscal year 2008, and has proposed almost $700 billion in spending for the Department of Health and Human Services. This is an increase of more than $28 billion in FY2008.

However, of this $700 billion, only about 10% is discretionary spending. The rest goes to our entitlement programs, including Medicare, Medicaid, SCHIP, TANF. These programs are encompassing a larger and larger amount of the federal budget each year, and the trend will only continue as baby boomers start retiring.

As Member of the Budget Committee, we are responsible for taking an honest look at these programs, figuring out what we can afford, and making the hard decisions about how to keep our spending in check and these programs viable for future generations. I am fearful that if we don't, our children and grandchildren will pay the price with significantly higher taxes and reduced benefits.

I don't think anyone wants to leave that as a legacy, but that is exactly where we are headed if we don't act soon.

The President's budget laid out some bold moves to start reducing entitlement spending. For example, in the Medicare program, the President has proposed changes that would reduce growth by $4.3 billion in FY08 and $65 billion over five years, along with achieving additional changes through administrative changes.

Under Medicaid and SCHIP, the President's budget would save almost $20 billion over five years.

While we may not agree or adopt with all these proposals, we should carefully consider them. The time to act on reigning in spending is now, and the longer we delay the more difficult the problem becomes to solve.

Thank you.

ANSWERS TO QUESTIONS FOR THE RECORD

Questions for the Record from
Senator Russ Feingold
Senate Budget Committee

Question: How does the President's FY 2008 budget request, as well as the upcoming supplemental, address the continuing rebuilding needs facing Gulf Coast residents, particularly in the area of permanent, affordable housing assistance?

Answer:

The Administration is committed to rebuilding the Gulf Coast. The Federal government has committed $110 billion for the recovery effort to date, and more than 75 percent of that has been obligated to date. Actual reconstruction, however, continues to be a locally-driven community process, which is then coordinated into overall state plans. A tremendous amount of work still lies ahead, and the Federal government continues to support and strengthen, but not replace, State and local government and private initiatives.

The Budget proposes $3.4 billion in supplemental funding for FEMA's Disaster Relief Fund to allow FEMA to continue providing housing assistance, public infrastructure repair grants, and other disaster recovery needs through 2007.

The President recently announced plans to extend FEMA's temporary housing assistance programs for an additional six months, through August 2007, with projected costs of over $500 million. During this extension period, FEMA will be working with the Gulf Coast States and other federal agencies to determine an appropriate path forward for hurricane victims who require further assistance.

$16.7 billion in Community Development Block Grant (CDBG) disaster funds was appropriated in response to the Gulf Coast hurricanes, of which only $1.2 billion has been spent. While there are no additional funds in the FY2008 Budget Request specifically for permanent, affordable housing assistance in the Gulf Coast States, the States are allocating some of the appropriated $16.7 billion in Community Development Block Grant supplemental funds for this purpose. In particular, there is a $1 billion set-aside of CDBG funds targeted for repair, rehabilitation, and reconstruction of the affordable housing stock. HUD also continues to work with state and local governments on rebuilding public and low-income housing.

Question:

I want to touch on reforming the Corps of Engineers. I thank the Administration for its support over the years. The Administration has supported reforms in each of the President's budgets for the Corps, in your Statement of Administration Policy on last Congress' Senate WRDA, and by supporting my independent review and prioritization amendments last July.

The President's budget again makes it clear that there is not enough money to construct all the projects in the Corps' enormous project backlog. This is the reality, despite the joke turned common day practice that if you need money, you go to the Corps. We need to get a handle on this situation. We also need to ensure the Corps is building sound projects and mitigates for any associated environmental damage.

Will the Administration continue to support reforms and come to the table and work with me, Senator McCain, and the authorizing Committees to ensure the inclusion of meaningful reforms in the next WRDA?

Answer:

Yes. The Administration would be happy to work with you, Senator McCain, and the authorizing Committees to enact legislation that will help to improve the performance of the Corps.

Question:

The Budget discourages childless adults from being covered under the State Children's Health Insurance Program (SCHIP). I'm concerned that this will lead to a policy of not covering any adults with program funds. My state of Wisconsin covers parents of Medicaid and SCHIP children in addition to pregnant women. There is excellent evidence that family-based coverage is better for children and families, and there is no other affordable insurance for these adults.

Does the President support states being able to cover these adult population groups under SCHIP? Would the Administration support states like WI continuing coverage of adults with SCHIP funds?

Answer:

The FY 2008 Budget does nothing to jeopardize current SCHIP coverage levels for adults. Under the FY 2008 Budget proposal, States can continue to cover certain populations of adults, particularly parents and pregnant women. The Federal match rate for parents will be slightly lower than the current enhanced match rate. However, reimbursement for these populations will average over 50 percent. The FY 2008 Budget will prioritize SCHIP resources on the population for which it was originally intended – low-income, uninsured children at or below 200% of FPL.

Question:

The President requested only $4.8 billion over five years in additional funds for SCHIP allotments. I understand the Finance Committee estimates that in order to keep existing enrollees covered it would cost at least $15 billion over five years.

Do you agree with the Finance Committee estimates?

How many children and individuals do you estimate will be dropped from the SCHIP rolls under the President's Budget request?

Answer:

The Administration is committed to reforming the allocation of SCHIP funds among States to increase program efficiencies by better targeting funds to states most in need. The $15 billion estimate is too high because the current program financing structure, which gives States three years to spend funds, prevents the timely and effective allocation of funds to states. Under the Administration's proposal, the allocation of funds would be reformed and the amount needed to maintain enrollment would be less that the $15 billion estimate. The Federal match rate for different populations would also vary to focus the majority of Federal funds on children at or below 200% of FPL. According to the HHS actuaries, the Administration's FY 2008 reauthorization proposal, which would increase allotments by $4.8 billion, is sufficient to maintain priority levels of SCHIP enrollment.

Question:

As you may know the current extension of the Milk Income Loss Contract (MILC) program expires one month shy of the end of the current Farm Bill, meaning the Farm Bill baseline will not assume any funding for the program. In October 2004, when the President was campaigning in Wisconsin, he promised on at least two occasions that he would support the MILC program that provides countercyclical support to dairy farmers when the prices are low. Despite those promises, the President's budget cuts the support rate for MILC over time and reduces coverage to only 95% of dairy production. Compared to the program he promised to support when he was in Wisconsin in the fall of 2004, the new program would provide 64 percent of the benefits in FY 2008, and drops to 38 percent by FY 2013.

Why does the President's budget and longer term goals for agriculture make such deep cuts to the MILC program, while other commodities, such as cotton, are projected to receive a more than 20% increase of several hundred million dollars per year?

Answer:

The President fulfilled his commitment to extend the MILC program by two years by proposing legislation to achieve that goal and signing into law an extension of the program. The Administration is now proposing to go beyond that commitment by extending the program an additional 10 years, although at a declining level.

The Administration's proposed reforms were designed to be equitable across commodities. As you may know, the Administration's proposal would reduce loan rates for all of the program crops. The same approach was applied to the MILC program, reducing the payment rate from the full 34 percent to 20 percent over time.

In the proposal, MILC payments would be based on 85 percent of the three-year average of milk marketed during fiscal years 2004-06. This policy change would make the MILC program consistent with the other farm bill counter-cyclical programs that are calculated on historical production bases.

MILC payments would also count towards a producer's overall counter-cyclical payment limit of $110,000 annually, and the new adjusted gross income eligibility cap of $200,000 annually would also apply.

Questions for the Record from
Senator Bill Nelson
Senate Budget Committee

Question:

Funding for NASA remains well below the 2005 authorization level that Congress passed. I plan to work with my colleague to increase this funding through the appropriations process to ensure NASA can continue to meet its main missions.

While NASA did receive a fairly sizable increase relative to other non-security discretionary spending in the budget, I remain concerned about what will happen in future funding years. With budget detail only going through FY 2008, but significant non-security discretionary spending cuts assumed in the budget – only 1 percent increases per year for the five-year budget window – I am curious to know how you anticipate NASA will be treated in these outyears?

What commitment and priority will NASA be given, or can we expect NASA will see only the 1-percent increases assumed in the rest of the non-security discretionary budget from FY2009 to FY 2012?

Answer:

I can assure you that the Administration's support for NASA and the vision for space exploration remains a priority in the outyears. For planning purposes, the budget assumes the following outyear funding for NASA after 2008:

2009	$17,614 million
2010	$18,026 million
2011	$18,460 million
2012	$18,905 million.

Question:

Restoration of the Everglades ecosystem is a huge priority for me, and for the state of Florida. In fact, the state has continued to live up to its obligations in acquiring land and supplying necessary infrastructure to further restoration projects.

Unfortunately, I don't believe the President's budget shows the necessary level of federal commitment to get this job done. In particular, the Comprehensive Everglades Restoration Plan (CERP) is significantly under-funded in his submission, just at a time when construction ought to be starting on a number of projects in the region.

At what percentage of capability is the Comprehensive Everglades Restoration Plan (CERP) funded under the Administration's proposal? What impacts will this level of funding have on the timeframe for reaching benchmarks in Everglades restoration?

Answer:

The Administration has designated the overall Everglades/South Florida ecosystem restoration effort as a national priority, and has funded this effort accordingly. The Budget used performance-based criteria to allocate funding among the projects in the civil works construction program. Using these criteria, the Budget included $162.4 million for the Everglades/South Florida ecosystem restoration program for FY 2008. This is roughly the same as the $164 million that we requested for FY 2007, and a substantial increase above the FY 2006 enacted level of $137 million.

For FY 2008, the Corps allocated $98.4 million of the $162.4 million to work outside of the CERP, which is 81 percent of the maximum that it estimates it could efficiently and effectively spend, and $64 million of the $162.4 million to work under the CERP, which is 58 percent of the maximum that it estimates it could efficiently and effectively spend.

The Corps and the Department of the Interior are working with the State of Florida to develop interim goals and targets to track progress on restoring the ecosystem. The Budget includes the funding needed to support continued development of these benchmarks. The CERP is part of the larger restoration effort and is inextricably connected to it. Achieving ecological success will require addressing a number of scientific uncertainties and overcoming the technical challenges, and will depend on how the Corps formulates the principal restoration features and how it operates them, and as well as an appropriate level of funding in the out-years.

Questions for the Record from
Senator Mike Enzi
Senate Budget Committee

Question:

I am pleased that the budget reflects the passage of the Surface Mining Control and Reclamation Act Amendments of 2006. Because implementation of this bill is so important to the State of Wyoming, I want to be involved as the Department of the Interior and OMB moves forward, so I hope you will keep me in the loop.

The budget does not detail where you are at in the implementation process. Can you provide me with an update?

Answer:

Thank you for your question. The Department of the Interior's (DOI) Office of Surface Mining and Reclamation Enforcement (OSMRE) anticipates issuing a Memorandum of Understanding with the Department of Treasury regarding how States and Tribes should receive payment of amounts equivalent to their balances in the Abandoned Mine Reclamation Fund, as required by the recent amendments.

OSMRE is also currently determining how several key provisions should best be implemented. It anticipates issuing certain necessary rules by late September 2007 including, for example, how to reclassify the reclamation priority of certain abandoned mine lands and how to establish Tribal primacy under the new law. Additionally, OSMRE continues to refine its cost estimates as it furthers its understanding of the amendments and receives updated information from stakeholders.

Question:

The Higher Education Act is up for reauthorization this year. I want to work with the Administration throughout the reauthorization process, and support many of your pending initiatives – particularly increasing the maximum Pell Grant award, but feel strongly that any new spending must be responsibly paid for.

I, along with other Senators, have concerns about using mandatory savings for discretionary spending, such as Pell Grant programs. Could you explain your proposal in more detail?

Answer:

The Administration is proposing to raise the maximum Pell grant award to $4,600 in 2008 and to $5,400 in 2012. This increase is fully paid for with mandatory reductions in the student loan programs. The President's Pell Grant proposal provides a specific level of mandatory BA solely to pay for the estimated costs of increases above the annual discretionary appropriation. Congress and the Administration would still retain full control of annual Pell Grant discretionary spending. The Administration would oppose making the entire Pell Grant program mandatory.

Question:

What are the premium increases that you are proposing for the PBGC this fiscal year, and why are you proposing them?

Answer:

The 2008 Budget re-proposes the premium reforms from the Administration's comprehensive pension reform proposal that were not included in Pension Protection Act of 2006, including:

- Authorizing PBGC's Board of Directors to adjust the variable rate premiums paid by underfunded pension plans.
- Extending the variable rate premium to a plan's non-vested as well as its vested liabilities.

These reforms will generate $10.6 billion in savings over ten years, improving PBGC's financial condition and safeguarding the future retirement benefits of American workers. Last year, President Bush asked Congress to strengthen protections for the pensions American workers rely on, and Congress responded by passing, with bipartisan support, the Pension Protection Act, which made sweeping reforms to the retirement system. The legislation strengthened the pension insurance system and significantly expanded opportunities to build retirement nest eggs.

However, the Pension Protection Act did not make the defined benefit pension system solvent. Further reforms are needed to address the $19 billion gap that still exists between the PBGC's liabilities and its assets and reduce the risk of a taxpayer bailout.

Question:

As Ranking Member of the HELP Committee, I strongly support sufficient FDA funding to carry out the agency's critically important mission. However, I note that in order to meet the President's budget request, three new user fees would be required. These new user fees total $53 million, but have not been authorized through legislation. This is close to half of the proposed increase for FDA in the budget.

In the existing user fee programs at FDA, FDA and the regulated industry typically negotiate out a new agreement on fees and goals, and the agreement is then sent to Congress for review. Has the Administration discussed these fees, particularly the proposed generic drug user fees, with the affected industries? If not, why not? If so, are they receptive?

Answer: The Administration shares your interest in an efficient, effective Food and Drug Administration (FDA). We believe that the new user fees proposed in the FY 2008 Budget will help the FDA continue to achieve the agency's public health mission.

The Administration had not discussed the proposed user fees with those outside the Administration prior to submission of the FY 2008 Budget. As you know, all budget information is considered pre-decisional within the Administration until the budget is transmitted to Congress. We are looking forward to working with the regulated industry, Congress, and other stakeholders to enact the proposed user fees.

The FY 2008 Budget proposes $15.7 million in new generic drug user fees. These fees will enable FDA to shorten review times and begin to address the growing backlog of pending generic drug applications. We anticipate that the industry will be supportive of the proposed fees, and we look forward to discussions with the industry and Congress.

Question:

"I noted that the budget request includes $30 million for the African Development Foundation and that the Foundation uses its appropriated funds to secure matching funds from its development partners, particularly African governments. I have been pleased with the progress the ADF has made in Africa and believe it is one of the most highly effective developmental programs the United States is currently funding.

Do you believe this type of development program where matching funds are secured could be used as a prototype to improve currently ineffective development programs? Would the use of matching funds from the private sector for this type of program help the United States achieve a balanced budget by 2012?"

Answer:

I am also very supportive of ADF's approach to small business development and grant-making in Africa.

I agree that there are lessons to be learned from ADF's business model that could be applied to other development programs and the Administration is applying these lessons to other assistance areas whenever and wherever this model is appropriate.

There is certainly recognition that leveraging contributions from recipient governments, and also from private sector partners and other donors, can increase the impact of our foreign assistance resources while reducing the burden on our budget and supporting deficit reduction.

Question:

I am pleased that the budget includes a substantial request to implement Title XVII of the Energy Policy Act of 2005, which deals with federal loan guarantees. I have been a strong supporter of this section and am pleased the Administration sees the value in helping the development of new technologies.

One technology that deserves strong consideration is coal-to-liquids technology. Because coal is our greatest energy resource, it must be central to any effort to become energy independent. Coal-to-liquids technology has the potential to replace a substantial amount of transportation fuel.

Does the Administration plant to help move forward the development of coal-to-liquids technologies as part of the loan guarantee program?

Response:

In implementing Title XVII of the Energy Policy Act of 2005, the 2008 Budget proposes a $9 billion loan volume limitation in FY 2008 for innovative advanced technologies that will: 1) promote energy security; and 2) avoid, reduce, or sequester air pollutants or anthropogenic emissions of greenhouse gases. The statute also requires that projects employ "new or significantly improved technologies compared to commercial technologies in service".

This year's budget proposes to concentrate on two categories of technology that correlate with the goals of the President's Advanced Energy Initiative: technologies to reduce or displace oil demand, or technologies that change how we power our homes and businesses. Coal to liquids technology would fit in the first category. Of course, each proposal will be evaluated separately to determine how well it meets the goals of the program, its technical merit, and its financial merit.

Sen. Crapo
FY 2008 Senate Budget Committee
Questions for the Record

Question:
Currently the Crime Victim's Fund brings in estimated annual receipts around $600 million, and spends between $600 and $700 million on victims' compensation and assistance activities. This year, the President's budget proposes the permanent rescission of growing accumulated surplus balances in the Crime Victim's Fund totaling $1.338 billion, and to fund the Crime Victim's Fund with general fund appropriations to be paid back out of the fines collected this year.

Is the President's position that yearly receipts from criminal fines and penalties will be enough to sustain the victim's compensation and assistance programs each year without transferring the burden to the taxpayer or sacrificing victim's services?

Answer:
I appreciate your concern about sustaining the crime victims' programs and doing so without adding to the burden of the taxpayer. The Budget does propose to sustain the level of funding for crime victims' programs in 2008 without transferring any burden to the taxpayer. I cannot promise that every year will see sufficient collections of criminal fines and penalties to maintain spending for crime victims. However, in four of the six past years, deposits and recoveries (net inflows) for the Crime Victim's Fund have greatly exceeded the spending (outflows) of the Fund, and for a fifth year, the inflows were very close to the level of spending. In only one year, 2003, has the Fund significantly drawn on balances. With this kind of track record, we expect that the future will be the same.

In most years, the Fund will experience greater net inflows than it does outflows. If, on occasion, we need to transfer funding from the General Fund in order to provide for crime victims compensation and services, that is a much smaller net burden to the taxpayer than continuing the use of a budget gimmick that allows the Crime Victims Fund's excess balances to be used each year to offset (pay for) $1.3 billion in completely unrelated spending. These are dollars that, in all likelihood, would have been saved—not spent on what, by definition, are not our highest priority programs—if not for the use of the Crime Victim's Fund as a recurring budgetary gimmick.

Question:

Does the President's proposed rescission take into account the potential shortfall resulting from delayed collections of criminal penalties, and if not, how do you propose the situation be dealt with?

Answer:

There is always a risk of a potential shortfall in collections of criminal penalties, although we believe, as I have indicated above, that it is a small one.

Question:

What is the President's response to the assertion by victims' advocacy organizations that Congress intended to have the fund kept only for victims' compensation and assistance and never moved to the General Fund?

Answer:

The Administration is not proposing to change the key element that finances most Federal funding for crime victims compensation and services programs – the use of criminal fines and penalties. I am also confident that the Congress, when it established the Crime Victims Fund, did not foresee that the Fund would accumulate $1.3 billion in balances that are allowed to roll forward each year and serve as an offset to permit higher spending for purposes completely unrelated to crime victims. We expect the deposits of criminal fines and penalties to sustain most spending for the crime victims programs for the foreseeable future. What we do not wish to see continue is the perpetual use of excess balances to justify other, unrelated spending within the budget.

Question:

We know that the oxygen community has taken some pretty big hits of late, with a new payment structure effective at the beginning of this year, and they still will be living with the reality of competitive bidding later this year. Would you be open to discussions with the pulmonary physician and oxygen user groups to structure a revised payment system that was based on actual clinical need of the patient AND achieved savings similar to your targets?

Answer:

We are always happy to discuss our proposals and alternatives that might be offered. I would note that together, Congress and the Administration have taken a number of steps to better align Medicare payments for durable medical equipment (DME) such as oxygen equipment with costs and beneficiary needs.

Even with these changes, however, there is evidence that Medicare and its beneficiaries are seriously overpaying for oxygen equipment. According to a 2006 HHS Inspector General report, Medicare will allow $7,215 for 36 months for concentrators that cost $587, on average, to purchase. The report also states beneficiaries' coinsurance for a 36-month rental is more than twice the average cost of a new concentrator.

Total payments for this equipment are not significantly different under the new payment structure. Our Budget proposes additional measures to better align payments for oxygen equipment with costs and need. This not only means savings for beneficiaries and taxpayers, but access to equipment for the period the beneficiary actually needs it.

Our Budget proposes no changes to payments for new oxygen generating portable equipment, or to payments for needed service and maintenance. Also, in contrast to last year, this year's proposal would not permanently transfer title of oxygen equipment to the beneficiary at the end of 13 months.

THE PRESIDENT'S FISCAL YEAR 2008 BUDGET PROPOSALS ON TAX COMPLIANCE

WEDNESDAY, FEBRUARY 14, 2007

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:07 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Wyden, Lautenberg, Stabenow, Whitehouse, Gregg, and Grassley.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. The hearing will come to order. We thank everybody for being here. We especially thank the Commissioner for braving the snows of Washington. We thank our colleagues, as well. It seems to be that much of Washington is shut down but we are open and ready for business.

I also want to wish Senator Gregg a happy birthday. He is 29 years old today. It is amazing how gracefully he has aged.

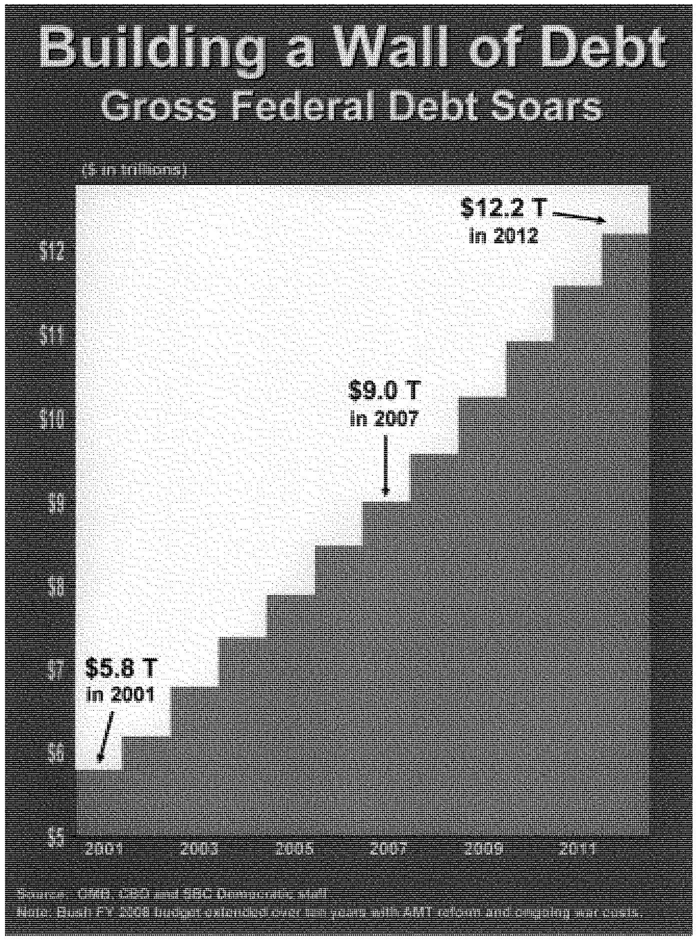
Senator GREGG. Do you have a chart to that effect?

Chairman CONRAD. I am bringing a cake. So happy birthday to Senator Gregg, and best wishes for this day.

I do not know exactly what the Senate schedule will be like with the weather outside, but we are going to go forward with this hearing.

I especially want to thank Commissioner Everson for coming today, and for sharing his insights with us. It is good to have the former chairman of the Finance Committee with us as well, but now ranking member, Senator Grassley.

Let me begin by highlighting the serious fiscal challenges that we see facing the Nation. I call it the wall of debt. We started out this administration, after the first year, with almost $6 trillion of debt. By the end of this year it wail be $9 trillion, headed for $12 trillion by 2012 if we do not respond.



It is very interesting, I would say to my colleagues on the Committee, in my work on this budget I find among our colleagues such a deep impulse to embrace every tax cut and embrace every spending initiative. Even though we all know we have to change, there is, among our colleagues, a great impulse not to change. It has been made very clear to me over the last several days.

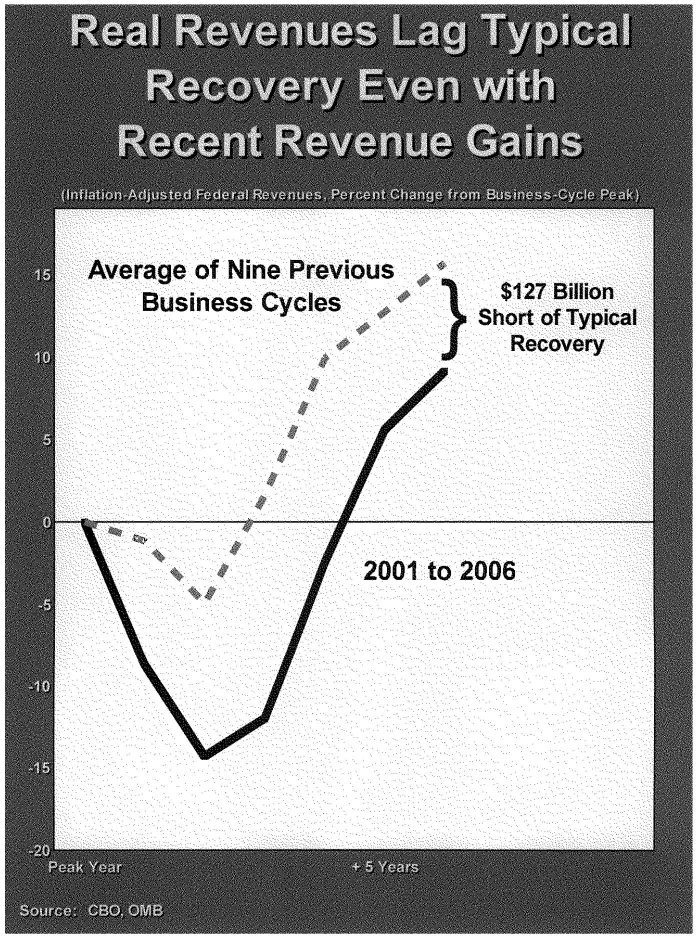
While increased spending has contributed to this growing debt, lower revenue has also been a factor. If we look at the revenue since 2000, back in 2000 we had just over $2 trillion of revenue.

We did not get back to that amount in real terms until 2006. We did not get back to the revenue base we had in 2000, in real terms, inflation-adjusted terms, until 2006.

And my colleagues are quick to talk about the revenue increase of the last several years, and they are absolutely right about that. If you just focus on the last several years, we have had strong revenue growth, which is typical of any recovery.

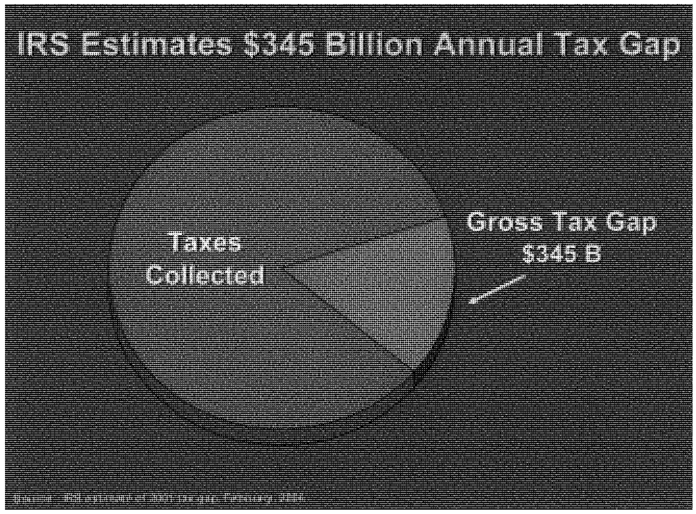
But what nobody wants to talk about is we have had 6 years of no revenue growth. The result is, with increased spending, is the debt has jumped dramatically. This is before the baby boomers retire. We are faced with a very inconvenient truth. And the inconvenient truth we are faced with is the baby boomers are going to retire and they are going to be eligible for Social Security and Medicare. We are going to have to do something about it.

Even with the recent revenue improvements, real revenues are still lagging behind where they would be in a typical recovery. We have looked now at the nine recoveries since World War II, the nine major recoveries, and we find we are still running $127 billion short of the typical recovery.



According to IRS's latest estimate, the tax gap in 2001 was $345 billion. The tax gap is the difference between what is owed and what is paid. My own belief is since 2001 that it is likely that the tax gap has grown even larger. I have long believed that closing the tax gap is one of the first steps we should take on the revenue side.

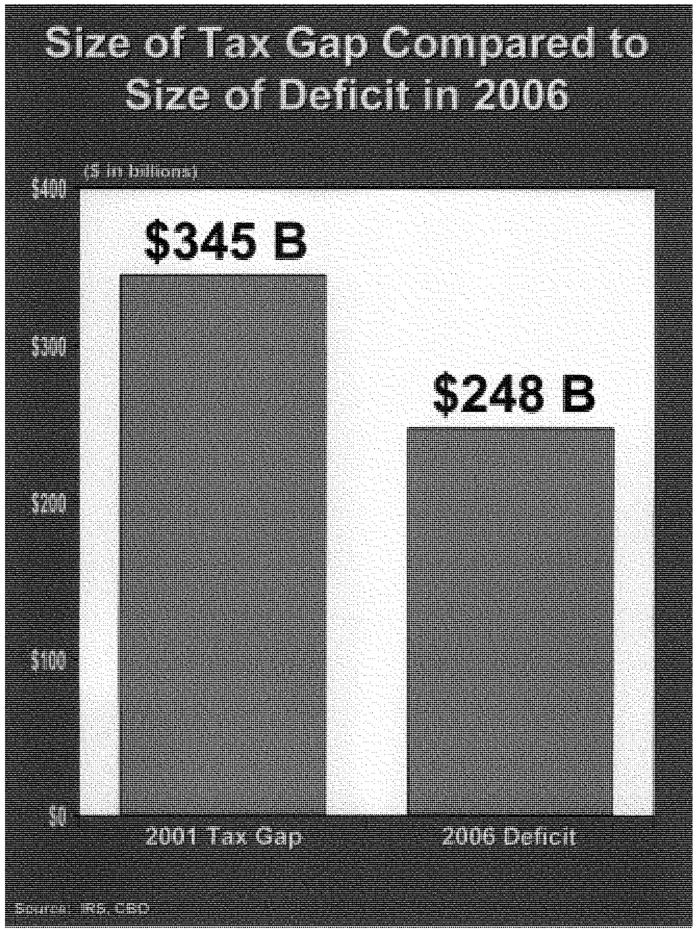
Let me be clear, closing the tax gap is not about raising taxes on anyone. It is simply collecting taxes that are already due and owed.

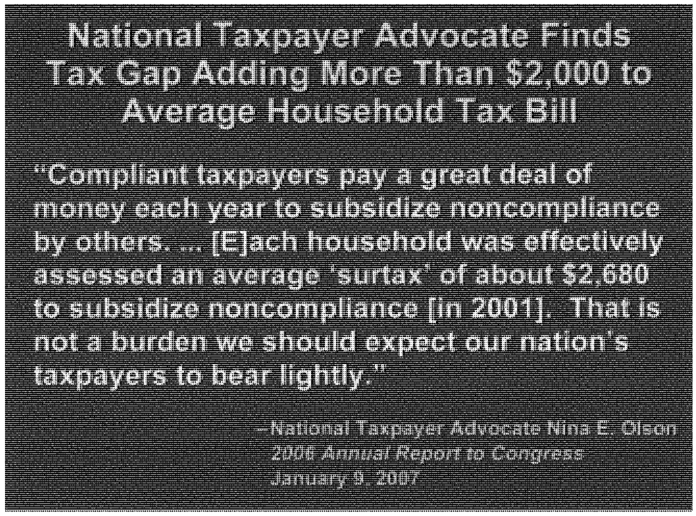


I want to salute the Commissioner for the strides that he has made in addressing the tax gap because he has moved on the enforcement side of the equation and moved aggressively. Frankly, I do not think we have given you the resources you need. I am especially troubled by the CR that took $100 million away from you on the enforcement side. That, to me, is going in the wrong direction.

The tax gap is simply unfair to the vast majority of American taxpayers who pay what they owe. And I believe the vast majority of taxpayers do pay what they owe. But we have, unfortunately, some number out there, and it appears to be a growing number, that do not. And that is true on the corporate side, as well.

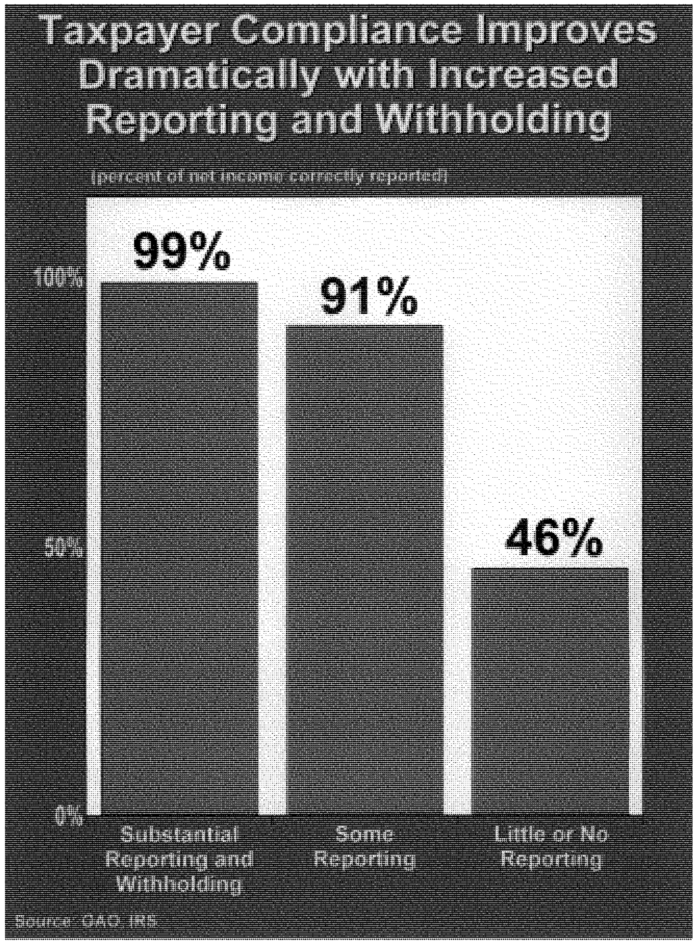
To put a $345 billion tax gap in perspective, consider that it is almost $100 billion larger than the size of the deficit in 2006. It is important to remember that the added burden placed on taxpayers from the tax gap is real. The National Taxpayer Advocate, in her report to Congress, wrote compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. Each household is effectively assessed an average surtax of about $2,600 to subsidize noncompliance. That is not a burden we should expect our Nation's taxpayers to bear lightly.


Size of Tax Gap Compared to Size of Deficit in 2006
($ in billions)
$400
$300
$200
$100
$0
$345 B
$248 B
2001 Tax Gap
2006 Deficit
Source: IRS, CBO



That is her conclusion, and I agree with it entirely.

To close the tax gap we need to improve reporting and withholding requirements. We know that taxpayer compliance improves dramatically with increased reporting and withholding. For example, according to the IRS, for income that is subject to substantial reporting and withholding requirements, such as wages and salaries, we see a 99 percent compliance rate. When reporting requirements are in place we see a 91 percent compliance rate. Where we have neither, we see the compliance rate dropping to below 50 percent.



So that is one part of the way forward, increased reporting. The other way is through better enforcement by the IRS. I am particularly concerned about enforcement that involves offshore tax havens. I used to be a tax commissioner. I have gone after these myself in my career. I have seen how incredibly lucrative it can be.

For six years I was tax commissioner in the State of North Dakota and four of those years I was chairman of the Multistate Tax

Commission. I dealt with this not only in the North Dakota context but on behalf of about 20 other states. And I personally reviewed the records of many large multinationals, and I saw how much revenue is hemorrhaging because of the games that are being played.

This very modest building in the Cayman Islands is the home to 12,000 companies, all of them claiming they are doing business out of this building. Amazing how many companies can do business out of there.

Of course, they are not doing business out of there. They are engaged in, for the most part, a giant tax scam. Those are the kinds of things we simply cannot permit to continue.

So with that, I am looking forward to the testimony of the Commissioner, and I again want to commend him publicly for the leadership he has provided there.

Senator GREGG.

OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Thank you, Mr. Chairman. Thank you for your wishes. I appreciate them.

It is nice to have the Commissioner here.

Chairman CONRAD. Can you tell us what birthday it is?

Senator GREGG. You know, being a member of the Budget Committee, I do not think I can add that up. It is too big a number.

It is nice to have the Commissioner here. He has done a very good job, I believe, and I thank him for his excellent work.

Obviously, this has been an issue, this issue of tax gap has been a major issue for the Chairman for many years. And I believe he has managed, through his perseverance and energy, to finally get us fairly well focused on it. And I will be interested in the Commissioner's thoughts on what the real numbers are that we can recover of this number that we know is the tax cap and how much we have already recovered.

I think the Commissioner's testimony may be that of that 2001 number, a significant effort has been made and there is significant recovery already occurring, and so that number has probably been reduced.

This is legitimate and what we need is a number that is reasonable so that we can figure it out and then give you the resources to accomplish that.

On the second issue, though, of what the tax cuts have done and what they have not done I must, whenever the Chairman puts his charts up, respond kindly to him that I think he is living in the past and maybe not looking at results that are current. You can obviously make a fairly effective argument that in the early 2000 period the revenues dropped precipitously.

I would argue they dropped precipitously primarily because we went into a recession, which was a function of two major events: the bursting of the Internet bubble which was the biggest bubble in the history of the world, bigger than the South Seas bubble, bigger than the—

Chairman CONRAD. Tulip.

Senator GREGG. Tulip Bubble, that is right, which was a big bubble, actually. But a bubble of disproportionate effect on our economy when it did burst.

And then second, the attacks of 9/11, which threw us into disarray as a Nation, emotionally, psychologically, culturally, and economically.

We have come out of that, though. We have come out of it primarily because we have put in place an economic program which has energized the economy. We have created 7.4 million jobs. We have had, I think, 34 months of continuous recovery and growth. We see revenues jumping dramatically in the last 3 years and 9 percent just in the last quarter, which is a huge jump considering that 9 percent is off a base that actually jumped by about 11 percent in the prior quarter, comparative quarter, and about 7 percent in the prior quarter to that.

We are now generating revenues, and this is the most significant point, which actually exceed the historic average of revenues to the Federal Government. We are up around 18.4 percent of gross national product coming into the Federal Government. Historically, we have been at 18.2 percent. And we are headed toward 18.6 percent, which are big numbers. Those are big numbers between 0.2 and 0.4.

So we are generating significant revenues at the Federal level. It is also important, I think, to appreciate the fact that the income tax has become even more progressive under the President's proposals, under the Republican proposals that were passed in the early 2000's under the leadership of Senator Grassley. We now have more progressive income tax law, where the top 20 percent of income tax—of earners in our society are paying almost 85 percent of the burden of the income tax, whereas under President Clinton they were paying about 81 percent of that burden.

And the lowest 40 percent of income earners, they do not pay taxes. They are getting more back under the Earned Income Tax Credit, almost by a factor of two, then they received back under President Clinton's period.

So we now have a tax law that is generating more revenues to the Federal Government than historically it has generated, and is more progressive. It taxes higher income—higher income people are paying more.

I congratulate Senator Grassley for having orchestrated that. I think the success story is significant and we should acknowledge that.

But there still remains this issue, which the Chairman and I totally agree on, which is that in the out-years we do not have a Government we can sustain because of the fact that we are facing a baby boom generation that is going to double the size of the retired population, which increases exponentially the cost of health care benefits and retirement benefits, and that our children will not be able to afford our generation when it is retired.

And so we should be looking for more places where we can more efficiently raise revenue. And I guess my questions to you will be along the lines of—after you have explained to us what really is the tax gap that we can still recover, what is that number—is there a better way to raise revenue independent of the tax gap? Is there a better way we can do this? Should we go back to an 1986 type of tax reform exercise where we basically consolidate, reduce the number of deductions? Actually reduce rates but clean out the underbrush of deductions?

I think you can be very helpful to us not only in explaining what the real number is that we could score and generally use, a hard number for covering the tax gap over the next 5 years, but if you have ideas as to how we can actually have a better system of taxation.

I thank you.

Chairman CONRAD. I am sure my colleague misspoke when he said 40 percent of the people do not pay taxes. I think he meant to say income taxes.

Senator GREGG. That is correct, I was talking about income taxes.

Chairman CONRAD. As he so well knows, a significant majority of the people in the country pay more in payroll taxes than they pay in income taxes.

Senator GREGG. But I would note that my statistic is correct, that for the bottom 40 percent who pay income—who are subject to income taxes, those folks do not pay an income tax, but rather they receive money back under what is basically an inverted tax system, through the Earned Income Tax Credit. And they are now receiving more money back, as almost twice as much money back, today as they received under the Clinton years.

Chairman CONRAD. And of course, not all of the 40 percent received earned income tax credit but some of them do.

Where we have a difference is there is no question that tax reductions help fuel economic growth. There is also no question that tax cuts do not pay for themselves. If they did, we could just cut taxes more and balance the budget.

So all of this is a matter of balance. How do we ultimately achieve balance so that we are not continuing to run up this massive debt? And that is a place where the ranking member and I entirely agree. We have to have some balanced approach to deal with this demographic tsunami that is coming at us.

And one approach that we hope is fruitful is to deal with the tax gap. And that is why we have asked for this hearing and asked, Mr. Commissioner, to have you here. So please proceed with your testimony.

STATEMENT OF HON. MARK W. EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICES, DEPARTMENT OF THE TREASURY

Commissioner Everson. Thank you, Mr. Chairman, ranking member Gregg, members of the committee.

I am pleased to be with you this morning to discuss the President's 2008 budget proposals on tax compliance. I am glad that the committee has again expressed an interest in this subject of tax administration, and is holding this hearing, even in this inclement weather.

Actually, I am not really surprised that two individuals from North Dakota and New Hampshire failed to be intimidated by what sends Washington into something of a tailspin.

And we did note in our records, Senator Gregg, your birthday, and we wish you many happy returns.

Senator GREGG. That must be an inside joke. You use that a lot, don't you?

Commissioner Everson. Thank you for your interest in our activities. I have been on this job almost 4 years now. And during this period we have worked hard to restore IRS enforcement capabilities. We have made a great deal of progress. As we discussed last year, for a period of time our enforcement functions largely stood down. Over the last several years I would suggest we have restored respect for tax enforcement and the need to comply with the law.

But I would add that we have not done so at the expense of service to taxpayers. In fact, Senator Grassley recently visited the IRS and he made this point, and made it publicly, that we have been able to bring up the enforcement level without a lot of complaints about service. That has been very important.

At the IRS, our working equation remains service plus enforcement equals compliance. I think we have a pretty good balance right now and are making strides in both areas.

Turning to the President's budget request for the IRS for 2008, I want you to know that I am pleased with the submission, which provides almost a 5 percent increase from the expected 2007 funding levels. Most significantly the request not only augments our enforcement activities, but also devotes moneys to rebuild our systems infrastructure and increase our research capabilities. I feel that the request reflects Secretary Paulson's and Director Portman's confidence that the IRS will use these moneys wisely and generate a positive return for the Government.

I know that a subject of keen interest to members of the committee, and to many others in the Congress, is the tax gap. By the tax gap, I mean the difference between taxes owned the Government and those actually paid on a timely basis.

Before taking your questions, I would like to make several observations about the tax gap. First, while the most recent National Research Program study did a good job of updating our numbers, we need more research to better identify the sources of noncompliance. We need to conduct this research on a timely and continuing basis.

Second, I think it is well understood that we will never be able to audit our way out of the tax gap. While simplification of our tax laws will surely help the vast majority of Americans who already voluntarily comply with those laws, I would note that we will actually have to complicate the code to change the behavior of noncompliant taxpayers, for example, by requiring more information reporting.

Third, in recent years we have, as you noted Senator Gregg, made progress in improving compliance, as indicated by the steady growth in our enforcement revenues—the direct moneys we receive from collections, audit, and document matching activities.

Fourth, to reduce the tax gap dramatically would take some draconian steps, ones that would fundamentally change the relationship between taxpayers and the IRS, require an unacceptably high commitment of enforcement resources and risk imposing unacceptable burdens on compliant taxpayers.

Nevertheless, there are reasonable steps that can be taken to improve compliance. We have made 16 such proposals. In order to further improve tax administration, I ask the Congress to fully fund the President's 2008 budget request for the IRS and to enact the 16 accompanying legislative proposals into law.

Thank you.

[The prepared statement of Commissioner Everson follows:]

WRITTEN TESTIMONY OF COMMISSIONER OF INTERNAL REVENUE MARK EVERSON BEFORE THE SENATE COMMITTEE ON THE BUDGET ON THE FY 2008 IRS BUDGET AND THE TAX GAP

FEBRUARY 14, 2007

Introduction

Good morning Chairman Conrad, Senator Gregg, and Members of the Committee on the Budget. I am pleased to be here this morning to discuss the President's FY 2008 Budget request, and the IRS' efforts to improve compliance with our nation's tax laws.

A Commitment to Service *and* Enforcement

In FY 2006, we continued making improvements in both our service and enforcement programs. This is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards "transforming itself into a modern institution that provides efficient and effective tax administration services to America's taxpayers."

Improving Taxpayer Service

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides good quality service through a variety of channels, such as its Web site, toll-free telephone lines and Taxpayer Assistance Centers. This is supported by the metrics that we use to measure the effectiveness of our taxpayer service efforts. In category after category we continue to see improvement in the numbers in our telephone services, electronic filing, and our IRS.gov access. This is demonstrated by the following:

- Electronic filing by individuals continued to increase, up 6 percent from TY 2005 (3 percentage points) to 54 percent of all individual returns.
- The level of service for toll-free assistance was 82 percent, about the same level of 2005 and up substantially from 2001. The level of customer satisfaction with the toll-free line remains 94 percent, the same as last year.
- The tax law accuracy of toll-free response improved to 91 percent from 89 percent in the prior year.
- Taxpayers continued to find IRS.gov a useful source of information about the tax system and how to comply with their tax obligations. Visits to the IRS Web site jumped nearly 10 percent in 2006 to more than 193 million visits.

- More taxpayers used the online refund status tool "Where's My Refund." In 2006, there were 24.7 million status checks, up nearly 12 percent from 2005.

Clearly, more work needs to be done by the IRS to improve services. But we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 through a Congressional mandate. We sent Phase 1 of the Blueprint to Congress in April, 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

- Improve and expand education and awareness activities: This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.
- Optimize the use of partner services: This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.
- Enhance self-service options to meet taxpayer expectations: This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.
- Improve and expand training and support tools to enhance assisted services: This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.
- Develop short-term performance and long-term outcome goals and metrics: This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint will be sent to Congress soon. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year Strategic Plan for taxpayer service.

The Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The Strategic Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder, partner, and employee engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance. More details on TAB Phase 2 will be available when the report is delivered to Congress.

While TAB remains a work in progress, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the Blueprint. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help.

The Blueprint also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding non-compliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance.

Expanding Enforcement Efforts

Another reason for the Oversight Board's positive assessment of our work in FY 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years."

One of the most obvious measures is the increase in enforcement revenue, which has risen from $34 billion in FY 2002 to almost $49 billion in FY 2006, an increase of 44 percent. Since 2003, Federal government receipts have also increased by $600 billion. In FY 2006, the Federal government collected over $2.4 trillion in total receipts. This is an historic level, with annual receipts up 12 percent over FY 2005 alone. In the past two years the U.S. has seen the highest year-to-year revenue growth in 25 years. Revenue growth has been the greatest for corporate taxes and high income individual taxes – both areas where we have substantially increased our enforcement presence in recent years.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This is almost 77 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in FY 2001 to 0.98 percent in FY 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in the category rose by almost 80,000 as compared to FY 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5.03 percent in FY 2004 to 6.30 percent in FY 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in FY 2001 to 10,591 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by nearly 30 percent growing from 3,305 in FY 2001 to 4,289 in FY 2006.

Finally, examinations of tax exempt organizations have also risen. In FY 2001 5,342 tax exempt examinations were closed. This has risen to 7,079 in preliminary FY 2006 numbers.

The President's FY 2008 IRS Budget Request

The first step in continuing the progress we have made to improve service and voluntary compliance is approval of the President's FY 2008 budget request for the IRS. That request is for $11.1 billion in appropriated resources and represents a 4.7 percent increase over the FY 2007 House-passed Joint Resolution (JR) level of $10.6 billion.

The request includes $3.6 billion in appropriated resources for taxpayer service and $7.2 billion for enforcement, an increase of 0.9 and 5.8 percent, respectively, over the FY 2007 JR level. This increase includes $56 million in initiatives supporting taxpayer service and $291 million is initiatives supporting enforcement. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The Budget also requests $282 million for Business Systems Modernization. This is a $69 million and 33 percent increase over the level in the House passed Joint Resolution.

If approved, we project that these investments will increase annual enforcement revenue by $699 million dollars a year, once the new hires reach full potential in FY 2010. This does not include the indirect benefits of these investments, which as I will discuss later in my testimony, could be several times the direct return on investment. In addition, we estimate that the legislative proposals for improving compliance that are in the Budget, which I discuss later, will generate $29.5 billion over the next ten years.

In addition to the broad goals of continuing the improvement of service and enforcement, the President's Budget request for the IRS will support a number of initiatives.

Enhancing Taxpayer Service

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the Internet, Taxpayer Assistance Centers (TACs), and Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS and reduces overall inadvertent noncompliance.

The FY 2008 Budget contains two significant taxpayer service initiatives. First, we are requesting $5 million to expand volunteer income tax assistance. This taxpayer service initiative will help expand the IRS' volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

Second, the budget contains a $10 million request to begin implementation of the TAB. As part of the TAB effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and Web site interaction enhancements:

- *Contact Analytics* provide a tool for evaluating contact center recordings for the purpose of improving understanding of service levels for potential enhancements.
- *Estimated Wait Time* provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.
- *Expanded Portfolio of Tax Law Decision Support Tools* enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.
- *Spanish "Where's My Refund?"* adds the ability to check refund status to the Spanish Web page on IRS.gov, enabling the Spanish-speaking community to receive the same level of customer service on the web as available to the English Web page.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Website enhancements are designed to maximize the value of IRS.gov, making the site taxpayers' first choice for obtaining the information and services required to comply with their tax obligations.

Improving Compliance Activities

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle time, increase yield, and expand coverage. As part of its regular examination program, the IRS is expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

The IRS is also expanding its efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are six specific initiatives proposed in the FY 2008 Budget aimed at improving compliance. These include:

- Providing $73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance. This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating for possible criminal referral, persons who have evaded taxes. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in FY 2010.

- Providing $26.2 million for increasing compliance for large, multinational businesses. This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in FY 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in FY 2010.

- Providing $28 million for expanded document matching in existing sites. This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in FY 2010.

- Providing \$6.5 million to increase individual filing compliance. This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and produce \$82 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010.

- Approving \$15 million to increase tax-exempt entity compliance. This enforcement initiative will deter abuse within tax-exempt and governmental entities (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (6 percent) and employee plan/exempt organization determinations closures by over 9,000 (8 percent) by FY 2010.

- Appropriating \$10 million for increased criminal tax investigations. This will help us to aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which includes an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity, foster deterrence and enhance voluntary compliance.

In addition to these initiatives, I should stress to you the importance of allowing us to continue with the private debt collection program. The use of private collection agents (PCAs) was authorized by the American Jobs Creation Act of 2004. As we continue to debate the efficacy of this program, I want to take this opportunity to make a couple of points for purposes of our ongoing discussions.

One issue that has been debated is the relative efficiency of using PCAs versus using IRS employees to collect the taxes owed. The most important question is not whether IRS employees or PCAs can do the job more efficiently, but rather whether PCAs collect money that would otherwise go uncollected. The IRS lacks the resources to pursue the relatively simple, geographically dispersed cases that are now being assigned to PCAs. It is not realistic to expect that the Congress is going to give the IRS an unlimited budget for enforcement, and if Congress provided the IRS additional enforcement resources, I believe those resources would be applied best by allocating them to more complex, higher priority cases that are not appropriate for PCAs.

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. We currently estimate that between now and FY 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years. From September 7, 2006, when cases were first assigned to PCAs, through

December 31, 2006, PCAs collected more than $11 million in net revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of between $1.4. billion through FY 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate PCAs' potential to help improve compliance and perhaps even to show the government how to be more effective in its own efforts.

Reducing Opportunities for Evasion

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

- *Expand information reporting* – Specific information reporting proposals would:

  1) Require information reporting on payments to corporations;
  2) Require basis reporting on sales of securities;
  3) Expand broker information reporting;
  4) Require information reporting on merchant payment card reimbursements;
  5) Require a certified taxpayer identification number (TIN) from non-employee service providers;
  6) Require increased information reporting for certain government payments for property and services; and
  7) Increase information return penalties.

- *Improve compliance by businesses* – Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:

  1) Require electronic filing by certain large businesses;
  2) Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes; and
  3) Amend collection due process procedures applicable to employment tax liabilities.

- *Strengthen tax administration* – The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:

1) Expand IRS access to information in the National Directory of New Hires database;
2) Permit the IRS to disclose to prison officials return information about tax violations; and
3) Make repeated failure to file a tax return a felony.

- *Expand penalties* – Penalties play an important role in discouraging intentional non-compliance. Specific proposals to expand penalties would:

1) Expand preparer penalties;
2) Impose a penalty on failure to comply with electronic filing requirements; and
3) Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income.

The proposed budget provides $23 million to implement these initiatives. This will fund the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

Enhancing Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively.

Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas.

However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

We conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program, which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for Tax Year (TY) 2001. This was less than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow us to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among the major tax gap components since the most recent compliance data were compiled (i.e., 1988 or earlier).

The NRP provided accurate data for determining the sources of noncompliance and for measuring changes in compliance rates over time. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target its resources and effectively provide the best service possible and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts. Research is also critical in helping the IRS to establish benchmarks against which to measure progress in improving compliance.

The FY 2008 Budget would fund two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This will fund research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance.

Unlike the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance data each year, and by combining samples over several years will provide a regular update to the larger sample size needed to keep the IRS' targeting systems and compliance estimates up to date.

The second research program funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

- Meeting taxpayer needs by providing the right channel of communication;
- Better understanding taxpayer burden;
- Understanding taxpayer needs through the errors they make; and
- Researching the impact of service on overall levels of voluntary compliance.

Continuing Improvements in Information Technology

Tax administration in the twenty-first century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology and the FY 2008 Budget reflects that commitment. The FY 2008 Budget requests $81 million to improve the IRS' information technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure. This infrastructure initiative will provide funding to upgrade the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers; automated call distributor hardware; mission critical servers; and Wide Area Network/Local Area Network routers and switches.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the FY 2008 Budget requests a total of $282.1 million to continue the development and deployment of the IRS' Business Systems Modernization program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE (Customer Account Data Engine) and AMS (Account Management Services) systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. In fact, our objective is that IRS operate similarly to what one expects from one's bank; account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all the information regarding that taxpayer, including electronic access to tax return data, and electronic copies of correspondence. Armed with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In FY 2007, the IRS will start development and implementation of the 1040 on the MeF platform, which is expected to take two years.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through Web-based front-ends and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, the business community, and government, but also contribute to operational improvements and efficiencies within the IRS.

Implications for the Tax Gap

On September 27, 2006, the Office of Tax Policy in the Department of Treasury forwarded to Congress the outline of a comprehensive strategy to reduce the tax gap. It detailed a seven-prong approach needed to implement a multi-year strategy to reduce the tax gap. Many of the specific elements in our FY 2008 Budget request support this approach.

Put simply, the tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

It is important to understand, however, that the complexity of our current tax system is a significant reason for the tax gap and that fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions.

Distinguishing the Tax Gap from Related Concepts

The tax gap is not the same as the so-called "underground economy," although there is some overlap (particularly in the legal-sector cash economy). The tax gap numbers do not reflect taxes owed on income generated from illegal activities. This makes up a significant portion of the underground economy. However, what we think of as the underground economy does not include various forms of tax noncompliance, such as overstated deductions or claiming an improper filing status or the wrong number of exemptions. These are all included in our calculations of the tax gap.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, even though we do not have the ability to distinguish clearly the amount of non-compliance that arises from willfulness from the amount that arises from unintentional mistakes. We expect future research to improve our understanding in this area.

If all reporting errors were unintentional, we would expect to see a relatively even balance between over reporting and under reporting. However, since taxpayer overstatements of tax appear to be much smaller than understatements of tax, one can reasonably infer that much of the gap is the result of intentional behavior.

The Most Recent Estimates

The results of the NRP individual income tax reporting compliance study were combined with earlier estimates concerning other taxpayer segments such as corporate taxpayers resulting in an estimate of the overall gross tax gap for Tax Year 2001 of approximately

$345 billion. The net tax gap, or what will remain after enforcement and other late payments, is estimated to be about $290 billion, corresponding to 13.7 percent of estimated total liabilities.

Noncompliance takes three forms: not filing required returns on time (nonfiling); not reporting one's full tax liability when the return is filed on time (underreporting); and not paying by the due date the full amount of tax reported on a timely return (underpayment). We have separate estimates for each of these three types of noncompliance. Underreporting constitutes over 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes almost 8 percent and underpayment nearly 10 percent of the gross tax gap.

The individual income tax accounted for about half of all tax receipts in 2001. However, as shown on the chart below, *individual* income tax underreporting was approximately $197 billion or about 57 percent of the overall tax gap. The NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) of the underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from income (i.e., statutory adjustments, non-business deductions, and exemptions) and from overstated tax credits.

Federal Gross Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**197**	**57%**
Understated non-business income	56	16%
Understated net business income	109	31%
Overstated adjustments, deductions, exemptions and credits	32	9%
Self-Employment tax underreporting gap	**39**	**11%**
Corporate and Other Underreporting	**49**	**15%**
Non-Filers	**27**	**8%**
Underpayment	**33**	**10%**
Total Gross Tax Gap	**345**	**100%**
Note: Detail does not add due to rounding		

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self-employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self-employment tax together, we see that individual underreporting constitutes approximately two-thirds of the overall tax gap.

The amounts least likely to be misreported on tax returns are subject to both third party information reporting and withholding, and are, therefore, the most "visible" (e.g., wages and salaries). The net misreporting percentage for wages and salaries is only 1.2 percent.

Amounts subject to third-party information reporting, but not to withholding (such as interest and dividend income), exhibit a somewhat higher misreporting percentage than wages. For example, there is about a 4.5 percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage of 8.6 percent. As expected, amounts generally not subject to withholding or third party information reporting (e.g., sole proprietor income and the "other income" line on form 1040) are the least "visible" and, therefore, are most likely to be misreported. The net misreporting percentage for this group of line items is 53.9 percent.

Observations on the Tax Gap

In the context of the President's Budget request, I would like to make several observations about the tax gap.

First, while the most recent NRP study did a good job of updating our numbers, we need more research to better identify the sources of non-compliance on a timely and continuing basis.

Second, I think it is well understood that we will never be able to audit our way out of the tax gap. And, while simplification of our tax laws will surely help the vast majority of Americans who already voluntarily comply with those laws, we will actually have to complicate the tax laws to go after the non-compliant taxpayers (e.g., by requiring more information reporting).

Third, we have already made considerable progress in improving compliance as indicated by the steady growth in enforcement revenues in recent years.

Fourth, to reduce the tax gap dramatically will take some draconian steps, ones that will fundamentally change the relationship between taxpayers and the IRS, require an unacceptably high commitment of enforcement resources, and risk imposing unacceptable burdens on compliant taxpayers. Nevertheless, there are reasonable steps, which I have outlined in this statement that can be taken to improve compliance.

Summary

The FY 2008 Budget request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in greatly improving compliance.

Based on our analysis covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return of an average of four dollars in increased revenue to the Federal Treasury. This return can be expected to occur when the full productive benefit of the investment is realized.

This 4:1 return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in non-compliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities. Stated another way, taxpayers who see us enforcing the law against their friends, neighbors or competitors are more likely to comply voluntarily and not risk the chance that we might audit them. We have no means to measure this indirect impact, but research suggests it is at least three times as large as the direct impact on revenue.

Our role is not unlike that of a highway patrolman. He will never be able to ticket every speeder, but he attempts to position himself in areas where he knows that his time is more likely to be spent productively. He also knows that every time he pulls a speeder over, other motorists see that and slow down as well.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President's FY 2008 Budget contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third party reporting.

An analysis of the data from the National Research Program of TY 2001individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third party reporting. For example, only 1.2 percent of wages reported on Forms W-2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third party reporting.

The FY 2008 Budget request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate $29.5 billion over ten years.

I anticipate that some of this year's Budget proposals will be criticized, perhaps because of concerns about their potential impact on small businesses. Our proposals are part of an effort to help small businesses and all other taxpayers pay less by collecting more of the taxes that are owed. In addition, while the information reporting proposals will inevitably impose some burden on compliant taxpayers, they are designed to minimize that burden and to help the IRS better target its audit resources, thereby reducing the number of burdensome audits that result in little or no change to compliant taxpayers' reported liability. The challenges that a small business faces are difficult enough without having to compete directly with noncompliant competitors. We have an obligation to support those compliant small businesses by ensuring that their competitors are also paying their fair share. This is not only a matter of fairness, but also a way of supporting compliant small businesses in their efforts to remain compliant.

Finally, full funding of the budget request will enable the IRS to improve its research with respect to the tax gap. Despite all of our progress, there is still much we do not know about the tax gap. Although the updated estimates provided by the NRP study are more accurate than our previous estimates, and more accurate than the estimates made at various times by others using more indirect methods, they have many limitations.

Tax gap estimates are useful for understanding the general areas and levels of noncompliance and the scope of the problem, but they are far from exact measurements. With the exception of the individual income tax gap, the estimates do not adjust for noncompliance that goes undetected during examination, and estimates are not even available for certain (minor) components of the tax gap.

It is also important to understand that the NRP study looked only at TY 2001 individual income tax returns. The study provided no new information on anything other than the reporting behavior of individual income taxpayers. The data used to estimate corporate compliance and other tax gap components are much older. The estimates are based on data such as the Taxpayer Compliance Measurement Program (TCMP), which we ceased doing in 1988.

To collect more data, we are currently doing an NRP study of reporting compliance of businesses filing Form 1120S (Subchapter S) returns. This involves approximately 5,000 Form 1120S returns from Tax Years 2003 and 2004, taken from a nationwide random sample. This is the first time the IRS has conducted a reporting compliance study across tax years, and it will require that we knit the data together to provide a comprehensive picture. We expect the study to continue through 2007.

Beginning in October 2007, the IRS will begin ongoing annual research activities that will ensure we have the most up to date compliance data possible to measure portions of the tax gap, focus our resources, and improve our audit selection criteria.

While I am confident we have made a significant dent in the tax gap, the lack of current data makes it difficult to quantify exactly how big of a dent has actually been made.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.

Chairman CONRAD. Thank you, Commissioner. I appreciate very much your testimony.

Let us get right to it. In previous testimony before the committee, you have indicated that you believed that we could capture $50 billion to $100 billion a year in additional revenue without dramatically affecting the relationship between the taxing authority and taxpayers?

Commissioner Everson. Yes.

Chairman CONRAD. You have now come forward with 16 proposals, many of them on the information side which I completely agree with. That is a place that you need our support.

Let me talk first about the budget side, because I look at what was done to you in the CR and I regret very much that you were reduced $100 million on the enforcement side from what was in the President's proposal. Is that not correct?

Commissioner Everson. I believe that is about correct, yes, sir.

Chairman CONRAD. That is an area, it seems to me, that should be made up to you. That would be the first area.

The second area, as I look at, being a former tax commissioner, I look at the infrastructure, especially on the technology side, especially on the information technology side. And I know what a profound difference it made to my operation when we had a great leap forward.

I have looked at the spending there and I believe it would be prudent to add some money there. We do not want to waste money. We do not want to give you money that you could not spend efficiently.

So it looks to me like the combined effect of those two would be $200 million or $250 million for 2008 and then something on that order, adjusted for inflation, going forward. If we were to provide you that kind of additional resources, could you employ them efficiently?

I know you are not here asking for more money. You have made that very clear to me. And I understand the way it works in an administration. I understand how that works. You fight for a budget.

But I will tell you looking at this, I look at the enforcement, I see that Congress took action to deny you $100 million that the President thought you should have. It seems to me that is just a mistake by Congress not to give you what was requested on the enforcement side.

And then I look on the information technology side and I know, I used to work very closely with the IRS on these issues when I was chairman of the Multistate Tax Commission. If you are going to be as efficient as you can be and have the spin off benefit of an improved information system, we need to put some more money there.

So I would ask you, if we were to give you another $200 million to $250 million, could you give us a plan on how you would deploy that and could you deploy it efficiently?

Commissioner Everson. Let me respond first that I would ask the Congress to give us a budget. We are now 4.5 months into this fiscal year and I do not have a budget for the IRS. That is not the way to run a railroad.

I would ask you, first and foremost, to finish your work on the budget and the appropriations before fiscal year 2008 starts. We can plan, we can make adjustments, we can be much more rational in how we run an agency if we have a budget before the year starts.

Second point I would make is I am pleased with this budget. I am asking for every penny of this budget and not a penny more. As you know from our discussions, I have been through four budget processes so far, and we have never been fully funded on the infrastructure. If you look at the combination of the infrastructure and the enforcement side, this core infrastructure line has been held sort of stable.

Chairman CONRAD. In fact, is it not the truth of the matter you have been—as I look back—you have been cut every year?

Commissioner Everson. We have been cut about $570 million from the President's request in the enforcement and infrastructure categories over that period of time. I would note the infrastructure is particularly important in the 21st century and that it does not just help on enforcement. It helps on the services side of the organization, too. It is very important in terms of processing returns, being able to answer questions, processing notices, a whole host of things that happen.

But what I would caution the committee, again I am not asking for this additional money. If you have a tight budget or you cut a budget, an organization responds by cutting capacity. That is what we do. If you grow a budget too quickly, you lose control. You do not want to lose control at the IRS. We will head back down a road that is not good. We have been very careful as we have brought back up enforcement.

So particularly on enforcement, I think there is an issue here. We have attrition and we have, as many agencies do, have a higher level of attrition that is taking place right now with the older work force. This is a Government-wide issue but one we have felt particularly acutely.

The combination of hiring to replace attrition and then adding new people for the over $200 million of enforcement initiatives we have means that we are about at the max of what we could take. It would be imprudent to throw more money at us in that regard, if you follow the concept. Just the ability to hire and train—

Chairman CONRAD. And I understand that absolutely. That is why I am asking you, we do not want to give you money that you cannot efficiently and effectively employ.

Commissioner Everson. Yes.

Chairman CONRAD. But you have been reduced from what the President concluded that you needed in enforcement, $100 million in 1 year. It seems to me clearly we ought to make that up to you.

And then on the technology side, it looks to me like you could, just looking at the budget submission, knowing what I know about where you are, that you could use another $100 million or $150 million there effectively.

We know you are not asking for more. You have made that very, very clear.

Commissioner Everson. You know, I cut a deal with the Administration. We work hard to get to a number that everybody can be happy with.

Chairman CONRAD. I know how that works and I respect it and I respect that you are a good soldier. But we have an obligation here, too. Frankly, Congress took this $100 million out of enforcement. I am asking if we gave you that $100 million back, could you effectively and efficiently employ that?

Commissioner Everson. We would take a look at that issue. Again, it comes down to the hiring. And on the infrastructure it comes down to a whole series of things we would have to look at. If you ask us, we will look at it.

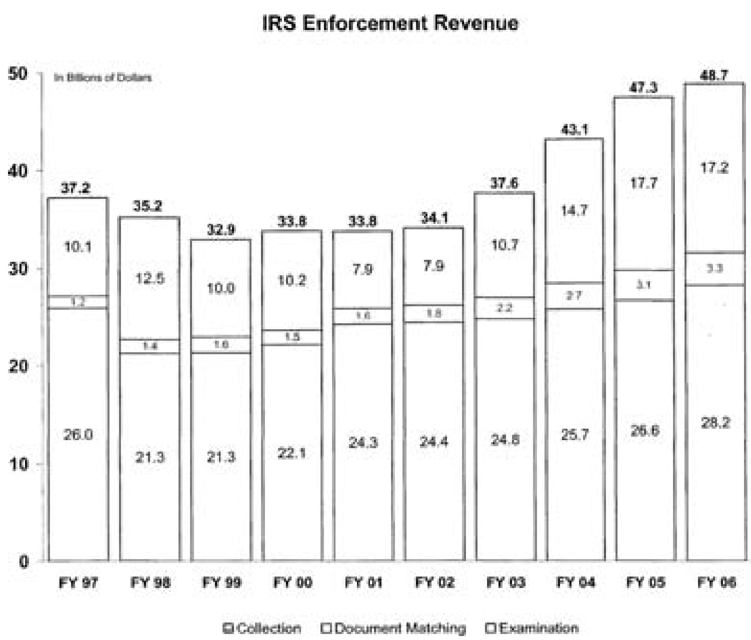
Chairman CONRAD. If we were to give you another $100 million or $150 million on the information technology side, could you effectively and efficiently employ that?

Commissioner Everson. That is somewhat less sensitive to the issue of absorption, but not totally insensitive to that issue. So again, you would have to be very careful as to where you spent that money.

Chairman CONRAD. Let us go back to the question, and I have gone past my time here.

When you previously testified, you indicated that we could—if all of the things were done that you were suggesting, that we could raise $50 billion to $100 billion a year without having a significant impact on the relationship between taxpayers and the taxing authority.

Commissioner Everson. Sure. This comes down to what Senator Gregg was referring to. If we look here, this chart shows the change in enforcement revenues that the IRS brings in over a period of time. The blue tube is the collections: money that people recognize they owe, but they have not paid, and that we get over a period of time.

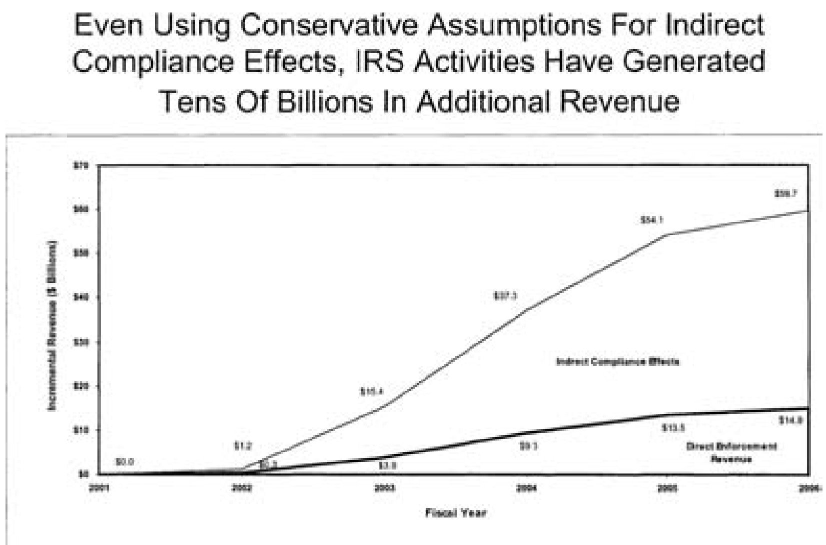


The yellow strip, that is our document matching activities. That process is when we send you a notice saying we have seen more dividends reported by the brokers than you have actually shown on the return.

And the green strip, which has shown quite a bit of growth, is audit results.

If you take the difference between 2001 and 2006—and 2001 coincides with when we did the studies that came up with the $345 billion and the $290 billion—the delta is about, I think, plus or minus $15 billion.

Now if we go to the next chart, the people who have studied this would say those moneys are just the direct impact. That is when we audit Kent Conrad and we know you are clean as a whistle—but it might influence your colleague, Senator Gregg, to be maybe a little less aggressive. That is the indirect effect.



Chairman CONRAD. He is clean as a whistle, too.

Commissioner Everson. Is he? Good.

Senator GREGG. You can take that to the bank.

Commissioner Everson. But the people who study this would tell you that, depending on the nature of the enforcement activity, there is an indirect compliance effect of four or five, sometimes 10, to one. What we have done here is said, even if you assume a very conservative indirect effect of three to one, that would indicate if you have a direct impact of somewhere around $15 billion, you might have already recovered $60 billion or so.

So I think that probably just by bringing up the enforcement—I do not want to be precise here. I would caution everybody to not try and get too exact here. I think we are probably somewhere around the lower end of that bracket.

Now what the Administration has done is put in some more money for service. You could argue about whether we ought to put in a little bit more. We believe that will get us additional moneys in, both directly and indirectly. And then we have put together a basket of these 16 proposals and that will get us some more as well. So I think we will get into this zone.

Now there has been conversation, I know my boss was here last week and also testified at Finance and elsewhere, with some people saying "jeez, you have to go further, this is a modest set of proposals." I think these proposals are quite significant in the sense that we have already got people screaming about the credit card reporting. That is, I think, the most important proposal. We are asking that for small businesses, which really very significantly understate their revenues, that we get the gross receipts once a year from the credit card issuers about a dry cleaning business or a restaurant or a car dealership. We think that will have a big impact.

But already we are into arguments where people are screaming about how much burden and how unfair some of these steps will be. What I would say to the committee is I am satisfied with the basket of proposals we have, just like I am satisfied with the budget. I think if we do these two things together we will get more squarely into this zone, this range.

You asked me that question last year, Senator, and that is when I offered a guess, $50 billion to $100 billion. But I think we will approach the middle of that range if we do these things that we have proposed.

Chairman CONRAD. All right. Senator Gregg.

Senator GREGG. Thank you. Picking up on that point, if I read these charts correctly what you are really saying here is that because you have ramped up enforcement significantly since 2001 and you have generated the $17 billion in real gain and enforcement, and then the $68 billion in what you think is enforcement that comes because people see somebody else being audited and they say well, I better get my act together, that really the increment that you are talking about that may still be available as low hanging fruit, so to say, would be between $68 billion and say $100 billion, somewhere in that range. So the increment on top of this probably is $30 billion or $20 billion, not $100 billion; is that correct?

Commissioner Everson. I think that is right. This gets harder with each additional step. Senator Grassley, of course, can comment on the struggles in Finance to get anything through to close some of these loopholes; it gets harder.

Senator GREGG. What I am trying to get to is a quantifiable number.

Commissioner Everson. Yes.

Senator GREGG. It looks to me, looking at your charts here, that what you are essentially saying is that over a 5-year period—and remember I presume you would again only ramp up—that by the fifth year you might be able to generate another $20 billion to $30 billion?

Commissioner Everson. I think if we got everything here, meaning the budget and the proposals. I think the proposals have been scored conservatively by the Treasury Department economists, and will been looked at by the Joint Committee economists conservatively, as well. And there are valid reasons for that, because oftentimes you will pass something into law and the IRS will not fully implement it because, for example, we will not get the money to do the document matching that we are now allowed to do from the third-party reporting.

But if everything works together, I think we will get that kick, that lift. I would not want to speculate that it would get as high as $30 billion. But when I think of the basket and compare it to

2006 where we say maybe haveten at the low end of that range, $20 billion would be a reasonable ballpark 4 years out.

Senator GREGG. If we were thinking about how we would score this budget-wise, assuming we could even get OMB to score it at all, which they probably would not, you would have to ramp up to that $20 billion. So over a 5-year period you are probably talking, because these regulations would go into—assuming you could even get these regulations passed—they would go in over a period of time. And certainly, for example, reporting capital gains basis would take a long lead-in.

Commissioner Everson. Yes, sir, that definitely ramps up overtime.

Senator GREGG. So we are probably talking a ramp up to say $25 billion or somewhere between $20 billion and $30 billion, which would mean over the 5-year period you might be able to score say $35 billion total, something like that.

Commissioner Everson. I do not want to promise a particular number, but you are looking at it conceptually correctly.

Senator GREGG. Conceptually and in a range.

Commissioner Everson. Yes.

Senator GREGG. So when you talk about these proposals, you have given us these 16 proposals. We are not the authorizing committee, obviously Senator Grassley is the former chairman and ranking member of that committee.

But I asked you if you could rate these on a—if you could give me the top four. And just for the public record, you told me the top four were—the first one you have already mentioned, which is getting gross receipts from merchants' credit cards.

Commissioner Everson. Yes.

Senator GREGG. The second one would be a felony for failure to file.

Commissioner Everson. Yes, sir.

Senator GREGG. The third one would be basis reporting on security sales.

And the fourth one would be failure to file electronically for businesses. Those would be the top four that you think would be the most—

Commissioner Everson. The last one is actually lowering the threshold where you make it mandatory to file electronically.

Senator GREGG. Which is a specific assessable penalty. No, it says establish specific assessable penalty for failure to file, so I may have misunderstood.

Commissioner Everson. That is actually a slightly different type of—

Senator GREGG. You are talking about expanding electronic filing.

Commissioner Everson. Yes, lowering the threshold for when you are required to electronically file.

Senator GREGG. So those would be the top four and then the rest, obviously the other 12 you would also like on top of those.

Commissioner Everson. What I would like to emphasize to the committee is these all work together. What happens is preparers and others respond to the overall change in the climate, and to the fact that the IRS and Congress are doing more. So, I am not trying to say it is an all or nothing proposal. But the more you do, the bigger this indirect effect, I believe, becomes.

Senator GREGG. I think that is just human nature and unfortunately OMB refuses to score—or CBO refuses to score obvious human nature, such as if you cut capital gains rates people free up capital and sell and generate more capital gains, things like that that are obvious are not obvious to some. But your point is obvious to me.

Thank you.

Commissioner Everson. We try to be practical at the IRS. We are not as smart as the economists.

Chairman CONRAD. Let me just say that I think you are being you too modest. If the tax gap net is about $300 billion a year times five, that is $1.5 trillion. And as I have heard your answer to Senator Gregg, it sounds to me like you are talking about recovering $30 billion to $50 billion of that. That would be, on the low side, one–500th of it, and on the high side one–300th.

Senator GREGG. He is saying—

Chairman CONRAD. What he has done is he has put a multiplier effect on a number that is hard. The multiplier is soft. If you put a multiplier on the tax gap that was identified by the Revenue Service back in 2001, $290 billion, if you put that same multiplier on it as he has put on collections, you would have a tax gap that was $1 trillion.

Senator GREGG. That is apples and oranges.

Chairman CONRAD. No, it really is not apples and oranges because he is saying that compliance has a ripple effect. Certainly noncompliance would have a ripple effect, too.

Commissioner Everson. I do not think that is fair, Mr. Chairman, because what we did our best to do in the NRP study was to measure at a point in time, and to come up with a real estimate of total noncompliance.

Chairman CONRAD. But isn't it the case that that point in time is 2001?

Commissioner Everson. Absolutely, that is correct.

Chairman CONRAD. But we do not know what happened between 2001 and later.

Commissioner Everson. That is why I am trying to be very general and not be precise when we get into, "is it $60 billion or $50 billion?" I am just trying to say I think we were already somewhere around the lower end of the bracket that you and I discussed last year.

Chairman CONRAD. I have a hard time believing that, I honestly do, because I know what happened. I have many contacts, as you know, and as you do, in the taxing profession and the accounting profession. They tell me the culture has changed dramatically and people have gone to a far more aggressive approach to how they approach paying their taxes.

Again, I would just say to you if the tax gap was $300 billion a year, 5 years, that is $1.5 trillion. What I hear you talking about here is it may be $50 billion. That is one–300th, according to my math. We have to do better than that.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman.

I want to, first of all, make clear to people who are watching that as we are talking about the potential for increased enforcement, the average American taxpayer, who feels a chill down his or her spine when he hears that phrase, is not really the focus of what we are getting at. We are getting at relatively complex schemes to dodge taxes; is that correct?

Commissioner Everson. Senator, on the first point, we say that we want to provide services to taxpayers because it helps them understand their obligation and facilitate their participation in the system. We enforce the law because average Americans, the vast majority, pay honestly and accurately. And they have every right to believe that when they do so, neighbors and competitors are doing the same.

But while you are correct that there is a lot of money in the high-end and the complicated shelters which we have been pursuing—my first priority over these last 4 years is to increase our penetration in high-income individuals and corporations. And we have done that. The majority of the tax gap is in under-reported income by individuals.

And the biggest single piece of this under-reported income is by individuals who are actually operating as a small business but unincorporated. This is the understatement of revenues, principally.

The difference is what I would say is—

Senator WHITEHOUSE. But it is pretty hard to deploy the limited resources that you have effectively on a case-by-case basis to make a case against an individual private owner.

Commissioner Everson. Yes, sir.

Senator WHITEHOUSE. Those are the people who feel the effects of it and get the message and comply. But the actual enforcement would presumably be directed against high income, high networth, and corporate entities.

Commissioner Everson. It would be a combination of things. What you are getting at is one reason why we are putting in the third-party reporting proposals.

Let me give you one example. The last time there was significant change in this area was in 1986, when there was major tax reform, as you may remember. That year we added a requirement to the 1040 for the Social Security numbers of dependents. The next year, even though the IRS did no matching with Social Security—it took us a year to get that going—five million dependents vanished. That is a lot and that is a lot of money.

Senator WHITEHOUSE. Well, let me give you a counter-example. This is a story from the Wall Street Journal that does not involve Federal taxes, it involves State taxes. But it is pretty remarkable.

It talks about Wal-Mart, and I will read just a few selections. "As the world's biggest retailer, Wal-Mart Stores Incorporated pays billions of dollars a year in rent for its stores. Luckily for Wal-Mart, in about 25 states it has been paying most of that rent to itself—and then deducting that amount from its state taxes.

The strategy is complex but the bottom line is simple: It has saved Wal-Mart from paying several hundred million dollars in taxes, according to court records and a person familiar with the matter.

"The arrangement takes advantage of a tax loophole that the Federal Government plugged decades ago, but which many States have been slower to catch. Here is how it works: One Wal-Mart subsidiary pays the rent to a real estate investment trust, or REIT, which is entitled to a tax break if it pays its profits out in dividends. The REIT is 99 percent owned by another Wal-Mart subsidiary, which receives the REIT's dividends tax-free. And Wal-Mart then gets to deduct the rent from State taxes as a business expense, even though the money has stayed within the company...

The so-called captive REIT strategy alone cut Wal-Mart State taxes by about 20 percent over one 4 year period..."

"The structure Wal-Mart is using"—this is the part I love—"features some unusual elements. Because REITs must have at least 100 shareholders to gain tax benefits, roughly 100 Wal-Mart executives were enlisted to own a combined total of around 1 percent of the REIT shares," all nonvoting. So they went and rounded up 100 executives and said guess what, you are a shareholder to make this thing work.

"A single Wal-Mart real estate official, Tony Fuller, represented the company both as tenant and landlords in its leases with itself. Ernst and Young, the accounting firm that sold the strategy to Wal-Mart, also is the company's outside auditor."

Now that is a ton of effort to go through just to beat one State's taxes. So I have to believe that if one of the biggest corporations, a proud American corporation, is willing to create what looks to me an awful lot like a dummy corporation, set up with its own executives as the shareholders, just to dodge it, there is a lot of dodging going on out there. And the poor regular taxpayer who owns his own little business or just is getting a salary, nobody can compete with that kind of cleverness.

Commissioner Everson. Senator, we set out and we started in this enforcement build-up to work on high-income individuals with the shelters and the corporations. And we have brought up the enforcement quite significantly in both of those areas. I agree with your assessment. I spoke 2 years ago in January to the New York State Bar Association taxation section. There were 98 tables of 10, and these people are not representing EITC taxpayers.

You are entirely correct, there is a lot of energy around complying and then making sure that you are absolutely minimizing tax, if not altogether getting out of tax.

We work hard on this. This budget requests more moneys for going after the high-income individuals who are engaged in these shelters. Our audit rate is now over 6 percent for individuals who are earning $1 million. That is a very high audit rate. We have $26 million more in here for the corporate arena and something like $70 million or $80 million to work in the small business and high-income individual areas. So we agree with you that is where you go.

I do want you to understand, though, that the big piece of the tax gap is in the individuals and small business area, which is not all high income people, just plain under-reporting income. We do not want to enforce our way out of this. What do want to get some help on the reporting.

Selected IRS Coverage Rates – FY 2006

Corporate with Assets > $250M	35.2%
Estate Tax with Gross Estate > $5M	23.5%
Corporate with Assets $10M - $250M	14.1%
Individuals with Income > $1M	6.3%
Individual Business with Schedule C	3.1%
Individual with EITC	2.3%
All Individuals	0.98%
1120S Corporations	0.38%
Employment Tax Returns	0.13%

Senator WHITEHOUSE. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Grassley.

Senator GRASSLEY. Thank you very much.

I am going to put a statement in the record that was leading up to my questions, so I can go immediately to the questions.

[The prepared statement of Senator Grassley follows:]

Chuck Grassley

Statement of Senator Charles Grassley
Senate Budget Committee Hearing
President Bush's FY 2008 Budget Proposals on Tax Compliance
February 14, 2007

Commissioner Everson, the tax gap is not a new issue. According to the GAO, the voluntary compliance rate has ranged from around 81 percent to 84 percent over the past three decades.

In the Finance Committee, we take the tax gap very seriously, because it's not fair to the vast majority of taxpayers that pay their taxes on time. We have had several hearings to examine the size, sources, and solutions to the tax gap, and we have enacted several steps to reduce the tax gap, such as boosting the IRS' whistleblower program and authorizing the private debt collection program. But we need to do more. Dozens of factors contribute to the tax gap and dozens of solutions are needed to close it. I am completely in support of taking appropriate measures to close the tax gap – and I will work aggressively towards enacting legislative changes to help close it - but it has to be done with care to be effective. There are no easy solutions.

There seems to be a general consensus that potential solutions to the tax gap fall into three categories: (1) Additional and more efficient enforcement by the IRS; (2) Additional enforcement tools for the IRS, such as information reporting and withholding; and (3) changes to our tax base that reduce the complexity of our current system, including reforming or eliminating some tax expenditures, as recommended by the Joint Committee on Taxation in a report called "Options to Improve Tax Compliance and Reform Tax Expenditures". I would note that some of the JCT staff's recommendations have been enacted, but there are many other proposals in that report that have not been enacted, such as repealing the deduction for interest on home equity loans, modifying the social security tax and self-employment tax rules, and moving to a territorial system for foreign business income. Others have suggested even more fundamental reform, like shifting to a consumption tax. Many of these changes, of course, would create winners and losers, making them controversial.

The second question I was going to ask has been pretty thoroughly handled by Senator Gregg. But I want to emphasize there, if I can, and ask you to shake your head without taking too much time because I want to get to the other four questions.

I think the bottom line of what you and Senator Gregg were speaking about it that the $50 billion to $100 billion figure of the tax gap, a lot of that is already in the baseline?

Commissioner Everson. That is right, sir. We have already achieved, probably, toward the lower end of that range.

Senator GRASSLEY. So then I want to interpret what Senator Gregg was saying about getting a quantifiable number. I do not know why Senator Gregg wanted to get a quantifiable number, but the reason I want to get a quantifiable number is because regardless of the fact that the Joint Committee on Taxation and CBO do not score revenue from changes in enforcement, a quantifiable number and a pretty hard number is pretty important. Because there is a lot of people over the next month or month-and-a-half, when we are having budget debates in the committee and on the floor, they are going to look at the tax gap as a pot of gold. And it is a legitimate question.

I have been working with Senator Baucus, he has been working with me. We are going to try to get all the money we can. But I want to make sure that we are talking about real money and not blue smoke. And there is a lot of people who are going to be counting blue smoke because they want it as offsets.

Commissioner Everson. I agree.

Senator GRASSLEY. They want it as offsets. So that is why it is very important for you to help us get as definitive figures as you can of quantifiable numbers, so we do not get a lot of this blue smoke involved in this offset game.

Commissioner Everson. Yes, sir.

Senator GRASSLEY. I am going to go through these other questions quickly because you are supposed to have some idea what I was going to ask.

How would the IRS have to change its enforcement practices to actually close the tax gap? How much more intrusive would the IRS be in the lives of taxpayers? And what kind of timeframe should Congress expect for the resulting revenues to come into the Treasury?

The fourth question, the President's budget contains proposals that would expand information reporting from credit card transactions, broker transactions, payments to corporations, and cost basis for security transactions.

Some members, and principally those on the other side of the aisle, have criticized these proposals as not going far enough because they only bring in about 1 percent of the tax gap.

So how could these proposals be strengthened? And what other types of income should be considered for expanded information reporting and withholding?

Fifth, in your view what role should tax reform and simplification play in this?

And the last question, these last two will be a little—let me go to the sixth one.

The role of the private debt collection program in going after the tax gap is how big of a factor? Would you answer those, which would be basically three, four, five and six?

Commissioner Everson. Let me sort of group the first two. What I would say is this gets back to this question of burden and balance, and when do you get to be too intrusive? The packet of proposals we have made, with the credit card reporting and others, we think, are significant; they already are generating a lot of squawking.

Other ideas that have surfaced. The taxpayer Advocate has talked about withholding, more withholding, on payments to independent contractors. I have opposed that, saying that I do not think that is something prudent to do now.

But there are any number of things that you can add to this package. You just get to the very difficult tradeoffs and add more burden for the people that Senator Whitehouse was concerned about a few minutes ago. That is the nub of this. That is where, if you really want to get big money, you have to go. But you are going to get a firestorm.

And I have to say again, just as the budget has not been passed, we had five of these proposals up here last year, as you know, and we got one through. So let's get these done before we talk about going any further.

Tax reform. We favor tax reform. I testified before the Tax Reform Panel, saying that simplification is a good thing. What I always say is that complexity obscures understanding. The fellow who wants to be compliant can throw up his hands and say, "hey, why bother? It is just too tough." Then the others, the fellows doing business—or purporting to do business-out of that house or building that you have shown, they use complexity and technology and all of the different subsidiaries that are mentioned in that article to obscure our understanding and make it tougher to catch them. So we want simplification. We really do. I support that.

The last point, and I am glad you raised this, on the private debt collection. This relates to the issue that we talked about before, adding enforcement personnel. As we have brought up our enforcement capacities that, in turn, generates more collection work because we provide more assessments. We do an audit and then we have to collect that money. So our collection activities are growing, as well.

Add to all of this the churning of our own people. And then we add people through this initiative. I can tell you that this private debt collection is critical to supplement what we are doing, because we would not be working these cases. We have already started this program successfully, got in some millions of dollars already. These are cases we would not be working in the next several years in any event, just because of capacity issues in terms of how quickly you can grow your work force.

So I am pleased with the program. We are monitoring it very, very closely to make sure we get the right quality, sir. And I think so far, so good.

Senator GRASSLEY. Thank you.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Commissioner, in your view, would tax simplification and tax reform be a significant help in closing the tax gap?

Commissioner Everson. I believe tax simplification will help. What is important, and I said it in my testimony before that Tax Panel a couple of years ago, you cannot compare a perfect theoretical system with an imperfect real system. You have to make an apples to apples comparison, though.

Because people talk, as you know, you have raised reform proposals yourself. People talk about VAT and other systems. Whatever system you choose, there are compliance issues with that system. That is what I ask people to consider. The other thing I ask people to remember is, whatever you do, if you did real simplification or real change, you would have a transition period that would run for some years. It takes us a long time to unwind what has happened in a given point in the year. So you just need to be attentive to those two factors, sir.

Senator WYDEN. We will be back at you on this topic. Chairman Conrad has put together a group here on the committee that is going to look at these issues. We will have some more to discuss with you in that regard shortly.

Let me ask you about a very troubling report that involves senior agents in the IRS complaining. This is the people with decades of experience complaining in the large corporate auditing unit that deadlines have been set by some of the political appointees that close the audits early.

The reason I find this troubling is that some of these employees have been in the IRS for decades. There is a fellow in Colorado who has been one of your auditors for three decades and he is speaking out publicly. He got asked to be transferred, and the like.

And so you hear his comments and you square it with what you have told us, which I have always thought was laudable, that you wanted to put a bigger focus on it. What is going on here? Are these agents just wrong? Because apparently there are a substantial number of them that are very outspoken and they are also describing specifically the techniques by which the agency is involved in some of these strategies that limit our ability to close the tax gap.

Commissioner Everson. I am glad you raised this issue, and I get the opportunity set the record straight on this. Let me make a couple of points.

First, there are only two political appointees in the IRS. I am one and the Chief Counsel is another. Two out of 100,000. We play it straight down the middle. I make decisions every day that favor the Administration or disfavor the Administration. And they are made without regard to politics.

I believe I do my job best by calling it down the middle. That serves the country, and I think it serves the President as well, because we all know there is a bad record when you try to reach into the IRS from the White House or anywhere else. So the first point I want to make is there is no politics in here.

The second point comes down to cycle time. I believe that one of the biggest problems we have in the system is the long period of time it takes to resolve tax matters. You will come up with an idea, and it will go into law, and it is not clear what the ramifications of that law is for up to 20 years. That is because the IRS takes several years to issue guidance on what you really meant. Then it takes us five or 10 years to get to an audit on a large corporation. We make an assessment. Then they go into the appeals process. And then it goes into the courts and it takes 5 years. It can take 10 or 20 years.

In today's world, that long cycle time is a detriment to compliance because the world is changing rapidly. Corporations need some stability to plan. And I would say to you, as a general principle, uncertainty is a bad thing for the compliant taxpayer and the length of cycle time is bad for us in terms of getting after problems.

Senator WYDEN. Let me, if I might, because I am running out of time. I think those are all valid points.

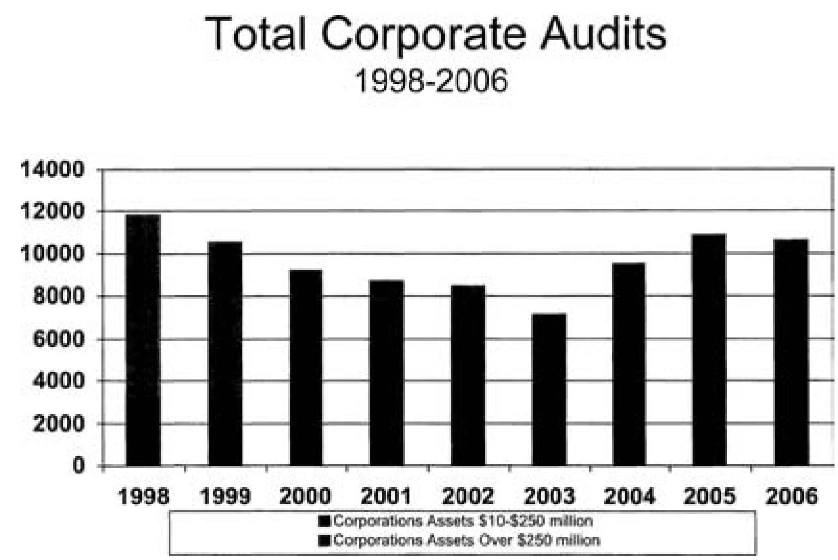
Commissioner Everson. I have some specific statistics I would like to show you, but I wanted to make that point.

Senator WYDEN. Good.

Commissioner Everson. Can I show those to you?

Senator WYDEN. Sure.

Commissioner Everson. Corporate audits, let us go to the audit numbers. The corporate audits on the biggest corporations, which were the subject of these discussions, reached a low point in 2003. That is the year I got there.



The audits are now higher—these are the biggest companies that he was writing about—than at any time in recent years. What we have done is brought up the penetration in the companies with between $10 million and $250 million in assets, where we were doing very little.

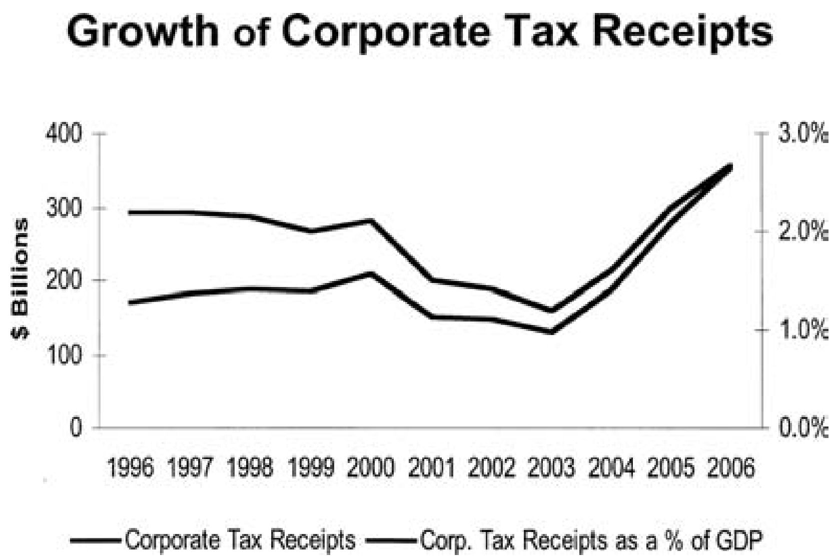
IRS Corporate Audit Data
2001-2006

Assets $10 m-$250 m	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Returns Audited	5,413	4,694	3,795	5,137	5,970	6,302
Dollars Recommended ($B)	$0.54	$0.63	$0.80	$0.76	$1.42	$1.31
Audit Cycle Time (months)	17.0	17.1	18.3	13.6	12.0	10.0
Assets > $250 m						
Returns Audited	3,305	3,749	3,330	4,386	4,859	4,276
Dollars Recommended ($B)	$12.77	$13.67	$12.29	$15.23	$30.14	$25.53
Audit Cycle Time (months)	31.9	33.2	32.8	29.4	31.2	29.0
Total Assets > $10 m						
Total Returns Audited	8,718	8,443	7,125	9,523	10,829	10,578
Total Dollars Recommended ($B)	$13.31	$14.30	$13.10	$15.99	$31.56	$26.84
Audit Cycle Time (months)	23.0	24.4	25.4	21.1	20.9	17.8

Now dollars recommended, which is what gets into, ultimately, the enforcement revenue. In 2003, when I got here, on these big companies we recommended $12 billion. That has more than doubled. Last year it was $30 billion and $25 billion in 2006.

I would be concerned if these agents were saying that they were being sent home to work on training or something and they were not doing work. But the truth is we are doing more audits. We have gone from 7,000 total audits to 10,000 total audits. And we have recommended more money. We have gone from $13 billion to $26 billion.

The final point I would make on this is that corporate tax receipts as a percentage of the GDP have gone to the highest level in 18 years. They have recovered to the highest level. They mirror profits. We put in the cycle time initiative and I would be very concerned if either what we were setting up was going down or not recovering. When I look at it in the big picture, I think it is OK.



The last thing I will say is individual managers may make a mistake in saying to employees, "you have to close this out and move on to something else." That is a difficult discussion. I am sure we are not perfect there. But I look at the big picture, Senator, and I think what we have done is responsible and correct.

Senator WYDEN. The only thing I would say, Mr. Commissioner, and I want to ask one other question, with the Chair's indulgence, is I have seen your numbers. I have heard you speak about this. And yet I read these reports about policies, coming from these senior people that are troubling. I would just like you to look into them and get back to me.

For example, apparently these senior auditors are saying they were told to limit questioning only to those specific issues that the IRS and the companies had agreed in advance to examine. So they get into the audit, they see other things, and apparently these people say they are not allowed to go further.

Would you get back to me on that?

Commissioner Everson. I certainly will and I appreciate your raising the question.

Senator WYDEN. Great. One last question, and I appreciate the Chairman's indulgence on this.

As both Chairman Conrad and Senator Grassley know—Senator Whitehouse has not gone through it—we have gone through a long debate about the question of Internet taxation. And what I and others have tried to do, and it is awfully arcane kind of stuff, is to say what we want to do is make sure that what applies off-line applies online. In other words, we would have neutrality. Nobody gets any breaks. Everybody is treated the same.

You all have been thrashing through this whole question of the auctions and brokers and the like. And there are some parts of the President's budget that raise questions in my mind with respect to making sure that there still is this nondiscrimination approach, as it relates to the technology companies.

The President's proposal, for example, requires reporting by brokers to the IRS. That strikes me as a constructive idea, as it will help in preventing tax cheats from getting away with their cheating and in closing the gap.

However, I am concerned that even though they are a broker under what is now the definition of a broker, the Joint Tax definition, that some may be trying to change the definition of a broker that could impact a variety of our technology companies.

Can you tell us your desires in this area? And particularly, I know it is hard to go through all of the details in a short exchange like this, your commitment to try to keep technological neutrality. We should not be favoring the on-line world. We should not be hurting the off-line world. What we have been trying to do is keep it in balance. Your thoughts.

Commissioner Everson. I am happy to get back to you in more detail on that, but my understanding of that proposal is that it does just what you have said, sir, which is it is neutral. The idea here is to sweep in brokers who hit a certain volume of activity. We do not want to burden somebody who is running a business—it could be a physical business or otherwise—where it is not even a business, let's say.

But if you are doing a real business and that is how you make your money, we want some reporting on it after you reach a certain trip line of volumes. The physical versus Internet piece is not, as I understand, a determining factor at all. So I think we are in the same place.

Senator WYDEN. Mr. Chairman, thank you for the extra time.

Chairman CONRAD. I want to go back over.

Senator GRASSLEY. Mr. Chairman, would I be able to get 5 minutes before 11:30?

Chairman CONRAD. Sure.

Senator GRASSLEY. Thank you.

Chairman CONRAD. Last year you testified before this committee—and Senator Gregg asked you this question: Let us say we were to take this number, $137 million, the President has asked for and double it. Could we presume that our return on that would be five times, 10 times? I mean, how would we—what, in other words, if we were going to offset that with receipts that we would score in our baseline, what would the number be that we would be considering putting in as a result? And when do we get to a diminishing return event?

Your answer: I do not think you will get to a diminishing return for some time. This gets to the basic question of how much can you reduce that tax gap. The way I view it is you can clearly reduce it by $50 billion or $100 billion without changing the way the government interacts with its citizenry.

And you had indicated that that was $50 billion to $100 billion a year.

Now you tell us, a year later, that all of a sudden, as I heard you say it, the most you could get is $30 billion a year.

Commissioner Everson. I think that if there is a disconnect here, it is that we were always talking about this 2001 starting point, which is where the latest research was. And I probably, to be clearer, should have drawn out all of the stuff that we were doing. You are right, I did not make that point as to what we were already doing. But I was looking at the reference point, as I do now, of the research in we did 2001. And then you get into that zone, as I have indicated.

I probably was not as clear as I could have been, Senator. Because that is where the number came from. The number came from 2001 and the work we did based on that point in time.

Chairman CONRAD. By 2001, we have two moving pieces here. We have 2001. If that is your base, is it your conclusion that the tax gap did not grow between 2001 and 2006?

Commissioner Everson. I believe we have made progress on the tax gap but obviously the tax gap—if all else was held equal, there were no changes—the tax gap would grow simply because the economy grew and the revenues grew. Whether you do it in real or nominal dollars, that is a different discussion.

But obviously, it changes. It also changes, sir, because of the change in the—you have different compliance rates on different revenue streams, as you can appreciate, as well.

Chairman CONRAD. I do.

It still leaves me baffled. Honestly, your testimony baffles me. I do not know how it can be that last year we could recover $50 billion to $100 billion a year from the tax gap. And now, as I hear your testimony, somehow magically that has been reduced to one-third of that.

When I look at the record on collections between 2005 and 2006 from enforcement, it has gone up by $1.4 billion. It went from $47.3 billion to $48.7 billion, a $1.4 billion increase. And all of a sudden your testimony of last year that was very strong, $50 billion to $100 billion, you said you can clearly reduce it by $50 billion or $100 billion.

And now your testimony this year is, as I hear you say it, $30 billion. How can that possibly be the case?

Commissioner Everson. Again, we are now talking about a higher number than I actually gave. Senator Gregg picked $30 billion. I did not pick $30 billion.

But again, it depends on your starting point, sir. I think that if you take a look at this, you talked about the revenue recovery since 2003. We have had this discussion, revenues have increased by over $600 billion. I think tax administration has played a part in that and stronger enforcement has contributed to that increase.

I do not want to try to be overly precise, but I do not think we are just starting from ground zero today.

Chairman CONRAD. I know but this is testimony—Mr. Everson, this is testimony you gave this committee last year.

Commissioner Everson. Yes, and I did not say starting from today. Perhaps I failed to be clear. I was always looking at the context of 2001. And I am sorry if that was not clear or I did not fully get that out. We have not been just sitting here. We have done quite a bit, as you know.

Chairman CONRAD. That is not my point.

Commissioner Everson. I understand. It is a different expectation. I understand.

Chairman CONRAD. My point is last year you testified very clearly before this committee and you said you can clearly—your words—you can clearly reduce it by $50 billion or $100 billion a year.

And now 1 year later, after a very modest increase in enforcement, actual collections, now you are all of a sudden at less than one-third.

Commissioner Everson. I do not think that is what I am saying at all. I am saying we are getting well over that. And if we did the research, we are going to start doing our research now.

Chairman CONRAD. All I can say is that is the most magical 1-year performance in history of tax administration.

Commissioner Everson. I did not say what the tax gap was. I never said what the tax gap was, sitting here a year ago. We are talking about 2001, sir.

Chairman CONRAD. Well, what you told us was—I do not know any other way to interpret your testimony, sir. Last year you told us very clearly—in fact your words—you can clearly reduce it by $50 billion or $100 billion a year.

Commissioner Everson. And I think we will have done that. When we next do the measurement, we will have seen that.

Chairman CONRAD. Based on 1 year of increasing collections by $1 billion?

Commissioner Everson. What we talked about before, all of what has been done since 2001.

Chairman CONRAD. I will tell you, it is not credible with me. I am a tax administrator. We have a tax gap, I believe, conservatively $300 billion a year, I believe conservatively. Because that is based on 2001. There is no way the tax gap has not gotten bigger given the aggressive nature of accounting today and given the growth of the economy. There is no way that it is not more than $300 billion.

Commissioner Everson. Let me say this, too.

Chairman CONRAD. And to say we can only collect $30 billion of that?

Commissioner Everson. Let me be clear, too. I do not want a fixed point so that if we are here a year from now we have a similar conversation. The tax gap will, again absent these mixed factors, if you just take the gap as a percentage of the overall revenue stream, that will continue to grow.

What we are talking about—and you have that baked into your budget projections anyway. That is baked into your budget projections, the continuing growth in the tax gap.

What I am talking about with the $50 billion or the $100 billion, was at any point bringing that down relative to where it would otherwise have been. So you have to consider all of those factors, the growth and then the onset, which is real progress as a percentage of the total revenue stream.

Chairman CONRAD. Are you saying to us that you can only recover 10 percent of the tax gap in a year?

Commissioner Everson. I do not think that is what we have said, at all. I think that what we said—

Chairman CONRAD. What percentage—let me ask you that way. What percentage of the tax gap over time, if Congress goes along with your proposals, can you close? What percentage of it?

Commissioner Everson. Starting from here.

Chairman CONRAD. Yes.

Commissioner Everson. Starting from here—

Chairman CONRAD. And what do you think the tax gap is starting from here?

Commissioner Everson. I do not have a precise number now. What I have said to you is if you look, coming back from that starting point, the $345 billion, we have done two things. We have made improvement through the recoveries, which is the extra $15 billion in direct moneys since 2001. And that recovery also has an indirect impact. So I am hopeful that if you measured today, did the same work, you would see some improvement in there. I think it gets toward—and again, I caution against real precision here. That was a pretty wide range—I think it gets toward the lower end of that range that we talked about last year.

If you now look going forward and you look at three things: the direct impact from the enforcement and the indirect impact that you are talking about in the budget; the legislative proposals; and the other point that Senator Gregg made that I did not draw out as precisely as I could have, the normal growth in our enforcementactivities.

Let us say if you take that at just 2 percent a year, you would expect, running a business, to get more productivity out of the business even with just a steady investment stream. If you just hold us to 2 percent a year there, then the impact of that is growth in that direct enforcement number as well.

So all of those things together, they mix up and they get to a number somewhere near what Senator Gregg was talking about.

Chairman CONRAD. So let me ask you, what is your testimony today? Last year you told us $50 billion to $100 billion a year. What is your testimony today?

Commissioner Everson. I will try to be as clear as I can and not over-promise the committee, because if I did that last year, if I was not clear enough saying looking at where we were in 2001, I apologize for that.

I think that if you look at these three things that I am mentioning—giving us the more money on both the infrastructure and the enforcement side, that basket of proposals, and the normal growth—I think that you are going to get a pop up by 2010 that might be somewhere around $20 billion, something like that. That is how I would bracket these things.

The numbers you have in the detailed budget submissions, they will tell you that we get $700 million on the enforcement initiatives and it would tell you that by 2010 you get $3.5 billion on the legislative proposals, if you do all of them. And I would say if you take the indirect effect of the productivity and the growth and the enforcement initiatives, that would account for the bulk that would get you toward—somewhere toward over $20 billion.

But again, these things all work together. I want to say, if we sit here next year or Senator Baucus is quizzing me, as Senator Grassley knows, “where is that money?” But you have not given us legislative proposals or you cut the budget or you say spend the money differently, you get to a very different answer.

Chairman CONRAD. Let me just tell you, my conclusion from your testimony is that you are talking about recovering maybe one in every $30 that is in the tax gap in a year.

Commissioner Everson. I do not read it that way, 70 out of—if you take—

Chairman CONRAD. But the problem is you are talking about dollars compared to a 2001 base. That is what you did apparently last year, your testimony this year, which I find baffling.

The tax gap is growing. There is no question in my mind the tax gap is growing. If it was $290 billion in 2001, what is it going to be in 2010? It would not be unreasonable to expect it to be double that amount. That would be $600 billion. $600 billion and you are going to collect $20 billion of it, that is one-thirtieth. That is 3 percent. That is pretty tepid.

Commissioner Everson. I do not think you are recognizing the progress we have already made.

Chairman CONRAD. You have made progress. What I do not buy is the notion that this tax gap, even with your increased efforts, is not growing. The economy is growing and tax avoidance is growing. And anybody that is in your business that does not know or does not testify before this committee that there is aggressive tax avoidance going on out there is not being straight with this committee, in my judgment.

Commissioner Everson. Senator, I have to take exception to that because that implies that I do not strongly combat aggressive tax avoidance.

Chairman CONRAD. No, sir, that is not what I said. In fact, if you listened carefully, I commended you for what you have done.

Commissioner Everson. I know you did.

Chairman CONRAD. But let's deal with reality. The reality is that the economy is growing.

Commissioner Everson. I agree.

Chairman CONRAD. The reality is global economy is growing. The reality is you talk to any accounting firm off the record, and you know it and I know it, and they will tell you that tax avoidance is growing and it is growing dramatically.

When we have 12,000 companies doing business out of a five-story building in the Cayman Islands and they all say they are doing business down there look, I know better. I have been a tax administrator. I have audited the books and records. And I have talked to people who I trust in the accounting profession. This kind of scam is doing nothing but growing.

That is not a comment on you, it is a comment on reality.

Commissioner Everson. Let me take one final pass at this and then I will retreat.

As Senator Grassley knows—he had a hearing last June—some of the issues get beyond what would be, Senator, in the tax gap itself. There is a lot of aggressive tax planning and what we called tax arbitrage. That is not captured in this tax gap. That is the use by sophisticated players to generate excess foreign tax credits or to take advantage of the difference between debt and equity, the treatment under the law between different countries.

That is not captured in the tax gap. But it can be at variance—and I stated my real concern about it—with the intent of what you pass in Congress. You can end up in a situation where a big company will end up paying tax neither here nor in the United Kingdom, as an example.

We are aggressively working on that. But it is a very tough line between what is legal and what is not.

Chairman CONRAD. Let me just say, we have had testimony before this committee on just that area. And people who are experts in this area sat at that table and testified that that area is burgeoning with the global economy.

Commissioner Everson. I agree with that.

Chairman CONRAD. And that is not even captured—

Commissioner Everson. It is not captured.

Chairman CONRAD [continuing]. In the tax gap. But I will tell you, that is not an area that I think involves hundreds of billions of dollars, hundreds of billions of dollars that is—not in a single year, but that is being avoided and evaded.

I have personally audited the books and records of large multinationals. I mean, I have followed them offshore. I have seen their books and records. I have seen what they were doing to dodge what they legitimately owe.

And the notion that we can only do $20 billion a year more in collection leaves me cold. I will tell you that.

Senator GRASSLEY.

Senator GRASSLEY. Thank you very much.

I think that the Chairman has brought up, in regard to that international economy, a good point. I think it is something that he and I been working on trying to change the law, to some extent, to close those. We have a long ways to go. But we have done some of that in the case of the shell corporations, as an example, in Bermuda. We have even some of it for ex-patriots in our small business tax bill on the minimum wage bill.

This first question is only because of the discussion you had with Senator Conrad, and it is not to combat anything Senator Conrad said. But when you come to estimating tax gap, isn't it true that like any other estimate it is a guide for us as policymakers?

Would you say that the estimate is as precise as what Joint Tax Committee might have for a specific legislative proposal? It surely cannot be as precise. So when you are talking about a tax gap, and there is a lot of taxes that are not being paid, but it could be $10 billion plus or minus, or it could be $50 billion plus or minus, could it not?

Commissioner Everson. You are entirely correct. We use the research for directional purposes and, when we get down to the level of specificity, to update our audit models.

The other thing though, Senator, as you know, is we try to run a balanced system. If you only made decisions based on just what is easiest or maybe most profitable, you would beat the bejesus out of the middle class and go after some things like more document matching.

Senator GRASSLEY. I think that the Chairman might be right in trying to pin you down on what you can get from enforcement. But the biggest part of what we are after in the tax gap is going to take place in these changes in the laws, of which you suggested and the Administration is suggesting is five. They suggested X number last time and we did not do anything about it. So it is not your fault, it is Congress's fault, if we are going to close the tax cap as much as we should.

Now those are things that Senator Conrad and I have to work on.

My third point would be just a comment on where I left off with you on the sixth question, where you spoke very positively about the need for private debt collection. Because we have this anomaly now. You are trying to institute something we told you to institute and you see it as being, at least initially, as a good thing.

For instance, we hear about creating good jobs in rural America. There is a company in my State that is doing one of these and it has good paying jobs.

They are also, it seems to me, trying to help us close the tax gap. It is part of it. And you have this ironic situation where people are complaining about not having enough good paying jobs in the private sector and about closing the tax gap. And then they want to shut down these private debt collection agencies. So I am going to keep making that point as people move forward to do this.

I do not think you have backed off any that these are very helpful toward closing the tax gap.

Commissioner Everson. We appreciate your support of that program and I have been clear on this—Congress asked us to do this. It is not a question, in my view, of whether it would be cheaper if the Government did it. First of all, we cannot, as I indicated, do it in the next several years unless we had a lot more personnel.

It is a question of getting money that we would not otherwise get. So that is correct, Senator.

Senator GRASSLEY. Then, following up on the reference to the culture of tax compliance, and Senator Conrad made a good point. I would like to raise a couple of points for you to comment on.

One, I would agree that in the late 1990's and early part of the decade, this decade, there was an out-of-control culture of noncompliance. However, due to the bipartisan anti-tax shelter legislation that we have done through the Finance Committee and through enforcement, we have changed that culture. Now there is a lot more, of course, we can do. We have proposals in the Senate version of the minimum wage bill that I have already made reference to.

Do you see any reason for delaying action on these compliance measures?

Commissioner Everson. Senator, I do not want to comment on the pending legislation.

Senator GRASSLEY. Could you comment just on the compliance measures, not on the process—

Commissioner Everson. The compliance measures are always important. We do want the Congress to act on tax administration issues as a general matter. I really do not want to go further than that.

But can I respond to one thing you just said though, it gets back to Senator Conrad? I do want to say that I believe—and Senator Conrad I would draw out this point, because I do not think I responded to your observation about the change in culture that Senator Grassley is talking about now—I do believe that while there are these challenges, particularly in the area of international and globalization and tax arbitrage, that the companies, the bigger companies have pulled back considerably from the blatant noncompliance which we have drifted to. It is not just the IRS, it is largely Sarbanes-Oxley and a series of other things.

So I agree with you, Senator Grassley, it is a whole series of things, in part what the Congress has done.

Senator GRASSLEY. You just brought up Sarbanes-Oxley. Would you agree that that has somewhat changed the culture in large corporations and there is probably more we can do in that area, particularly in the economic substance area as well, because there is uncertainty and inconsistency in how the courts apply the substance doctrine to a greater extent.

In fact I think there was a case that was just decided in the District Court level that the IRS won on some economic substance grounds, but lost on the penalty issues.

Commissioner Everson. Yes, in Texas, I believe.

Senator GRASSLEY. We have a responsibility to clarify it. But you know, it is very difficult to get some of that stuff through. Maybe the changed climate here would do it. But Sarbanes-Oxley has probably helped that to some extent?

Commissioner Everson. I think Sarbanes-Oxley has had a positive impact on the corporate tax compliance.

Senator GRASSLEY. Mr. Chairman, that is the end of my questioning.

Chairman CONRAD. Thank you, Senator Grassley.

I want to go back at this because honestly your testimony here today is among the most baffling I have ever confronted. It really baffles me. Last year you testify to this committee—let's put that up. Let's put up the quote. This is what you told us. You can clearly reduce the tax gap by $50 billion or $100 billion without changing the way the Government interacts with its citizenry.

Now this year your testimony is you are down to $20 billion.

I look at your chart. I look at—we do not have 2007 data obviously, but we have hard numbers from you that your direct enforcement revenue from 2005 to 2006 went up by $1.4 billion. You say on this indirect compliance effect, which is a multiplier on what you are actually doing, I do not know what you have to back up this multiplier. I have never seen such a thing applied, frankly. I have always looked at direct dollars.

How much did you increase, dollars in the door, by enforcement? Your chart shows 2005, $13.5 billion; 2006 $14.9 billion. That is a $1.4 billion increase. That is about a 10 percent increase year over year.

And yet last year you testified before the committee, as I have indicated, that we could recover $50 billion to $100 billion a year. Now it is $20 billion. How can that be? How do you reconcile that?

Commissioner Everson. Again, I think we talked past each other and I clearly was not as precise as I should have been, saying we were starting at that gap in 2001. And the next time you measure that—

Chairman CONRAD. But that makes no sense.

Commissioner Everson. It may make no sense and perhaps—

Chairman CONRAD. 2001 is the last time you have data for what the tax gap is.

Commissioner Everson. I am sorry? That is the last time, yes.

Chairman CONRAD. The only relevance of 2001 is that your agency's estimate of the tax gap was based on 2001 data. That is the only relevance of 2001. You were not testifying last year on something other than where we were last year. Where we were last year was what you were doing in compliance, what you were doing in enforcement, and what could be recovered if we did a better job and if we gave you more resources and we did the other legislative proposals that were before us.

So I honestly do not know how $50 billion to $100 billion turns into $20 billion with the only evidence of actual direct enforcement revenue increase is $1.4 billion. How is that possible?

Commissioner Everson. Again, I think we are measuring from different starting points. Senator, the only way this will be resolved is, as we get, presumably, this money and do more research, we will see whether the compliance rate is better. And then you measure that against all of what we talked about, including the size of the economy. If you assumed a stable rate on all those streams, did we make that improvement?

Chairman CONRAD. How much money do you collect a year in revenue?

Commissioner Everson. $2.4 trillion is what we took in last year.

Chairman CONRAD. $2.4 trillion?

Commissioner Everson. Yes.

Chairman CONRAD. In a future year you can do $20 billion more, that is what you are telling us?

Commissioner Everson. Just in a couple of years from now.

Chairman CONRAD. In a couple of years from now, when you will probably be collecting $2.5 trillion, you are going to collect $20 billion more?

Commissioner Everson. Again, this goes back to several points.

Chairman CONRAD. What is that as a percentage?

Commissioner Everson. I guess that is right. This is maybe a better place to have the conversation, going forward, let us talk about that. I think, that is a better place to be.

First, there is a limit, again, on how much we can add into this capacity of the service.

Chairman CONRAD. Tell me how much is $20 billion of $2.5 trillion?

Commissioner Everson. It's about 1 percent, a little bit below 1 percent.

Chairman CONRAD. Less than 1 percent, about 0.8 percent.

So you are telling me that the best that you can do is to increase this by 0.8 percent?

Commissioner Everson. Well, 0.8 percent on total revenue is a pretty big move. Let's assume, just for this argument, that you take my side for just a minute and you say all right, maybe—

Chairman CONRAD. I have been on your side. That is why I find this—

Commissioner Everson. I know you are.

What we are trying to do here is positive. We are trying to set expectations. And I apologize for any part I have played resulting in higher expectations. But if you look at that—

Chairman CONRAD. I will tell you, without higher expectations we do not accomplish anything.

Commissioner Everson. Fair enough.

Chairman CONRAD. That is a problem with this town, nobody wants to go on the line to accomplish anything. It is unbelievable the way this town is about reducing expectations so they do not have to produce.

Commissioner Everson. Let me say, though, that if you looked at this noncompliance rate before our recoveries, and that was based on the 2001 research of overall 16.3 percent, if you follow me. It was like 83.7 percent is the overall, if you look at the mix. And just take broad numbers.

Let us assume $20 billion, more or less. That would be, if you add the $20 billion to the $50 billion. If you assume that I am directionally correct, you are more or less somewhere in that ballpark. That would be a 3 or 3.5 percent reduction of the 16 percent. That would be cutting that noncompliance rate by maybe 20 percent. That is a big move in a big complicated system.

And I cannot tell you sitting here, with all of the factors like you have talked about and—

Chairman CONRAD. Let me just tell you what I do not believe. I do not believe the tax gap was static between 2001 and 2006. Do you?

Commissioner Everson. I do not believe it was static. I agree that there were a lot of factors in there. That is why I do not want to be overly precise. But I believe that we have made some progress.

Chairman CONRAD. Just notionally, did the tax gap grow between 2001 and 2006?

Commissioner Everson. It clearly would have grown because of economic activity—

Chairman CONRAD. Not only because of economic activity but your own testimony shows compliance dropped. Yes, 2003 was a low point according to your charts.

Commissioner Everson. Yes, and then it has recovered significantly, yes.

Chairman CONRAD. Right.

Commissioner Everson. If you compare 2001, look at the delta on these numbers here, the 2001 versus 2006. That is up $15 billion. That is not up the $1 billion you were talking about. It is up $15 billion. And that is what I am talking about.

Again, these are very fair points to debate. We believe there is an indirect impact. I believe that is real. I think that the problems that Senator Gregg was talking about before, of the economy with the recession and 9/11, I think those were compounded by the IRS drawing down its resources in that period.

Chairman CONRAD. When you show—the $1 billion I am talking about is from your chart.

Commissioner Everson. Yes, the difference in one—just 1 year—that chart is derivative of that chart there.

Chairman CONRAD. And that is direct enforcement revenue.

Commissioner Everson. That comes right off of that number there.

Chairman CONRAD. So I am using your numbers when I talk about direct enforcement revenue went up from $13.5 billion to $14.9 billion.

Commissioner Everson. Right.

Chairman CONRAD. Let me ask you a broader question because we have this whole area that you have acknowledged is not captured in the tax gap at all. It is not in the tax gap calculations. And it is the amount of money that is flowing through these international entities to avoid taxes not only in this country but to avoid them up right around the world.

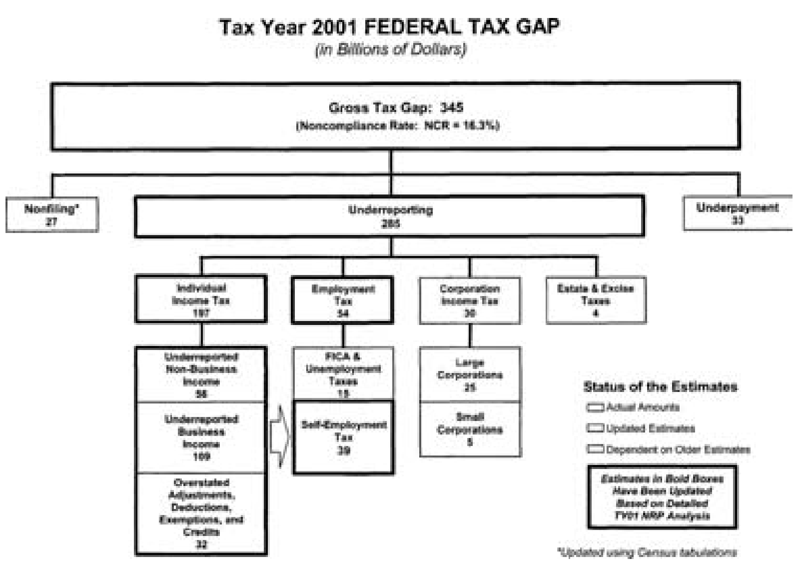
And we see, I see, and when I talk to people in the accounting profession, they tell me this is exploding. And that is not captured in the tax gap at all; is that correct?

Commissioner Everson. There is a lot in what you just said. And portions of it, I would suggest, are captured and portions are not. Let us go to the tax gap map.

The first thing I would tell you is we did not update our research on corporations in the 2001 study. And that is a very clear soft spot.

What I have said when questioned on this is that it would not have changed my resource allocation because we already have a very high audit rate on those companies, as I was talking about with Senator Wyden.

But I believe undoubtedly that number there, the $30 billion on the C-Corps, was understated and significantly. But it would not change the relative parameters that the big piece of this gap is in the individuals.



Chairman CONRAD. But I am talking now about other things because tax gap is not illegal activity.

Commissioner Everson. That is right, and let me make a couple of points here.

We have traditional areas that are very tough. Transfer pricing—very, very tough to deal with. That would be, if you updated this—and we are going to start to do some work on the corporations—that would fall into this tax gap, if we assess an extra $500 million for a big company or something.

The problem on updating this gets back to this long tail here. Just because our auditors set up $500 million, how do you say what the real noncompliance is? Because by the time you are done it has gone through an appeals process in the courts, it might be $200 million. So it takes a long time to be precise.

Chairman CONRAD. Believe me, I know how all that works.

Commissioner Everson. But let me give you the other piece because it is real. Arbitrage and all the other things that take this line as to whether it is in this complicated code or past it, that line is constantly challenged by all the intermediaries.

Now I do not want to give the impression that we are not trying to address it. I testified to Senator Grassley about what the big issues are, one of them being this arbitrage. We are addressing it aggressively.

We started something called the Joint International Tax Shelter Information Center. It is here in Washington. It is a partnership between the United States, the United Kingdom, Canada, and Australia. It is working on these kind of transactions. We have been too slow at working on complicated transactions.

I chair an OECD group of tax administrators, and we had a forum in Seoul, a meeting of some three dozen countries. That group is concerned about this. We have commissioned a study—

Chairman CONRAD. Why was this group formed?

Commissioner Everson. The OECD group of tax commissioners? To share information. And then we put a finer point—

Chairman CONRAD. But why to share information? What are you concerned about?

Commissioner Everson. We are concerned about just what you are getting after. What are the best practices? What is happening in most countries?

Chairman CONRAD. Most of this is not included in the tax gap calculation?

Commissioner Everson. I am sorry?

Chairman CONRAD. Most of this would not be included in the tax gap calculations?

Commissioner Everson. Again, some would, but much would not. If you are dealing in the tax arbitrage area, much would not be.

Chairman CONRAD. Let me ask you, why do you think—here is this building in the Cayman Islands, a nice-looking building, a five-story building. Why do you think 12,000 companies call that building home? Do they just like the weather down there? Are they down there to golf? Why do you think they got—

Commissioner Everson. I have never been to the Cayman Islands, sir.

Chairman CONRAD. What do you think 12,000 companies call that building home? Do you think it has anything to do with taxes?

Commissioner Everson. I am with you on this. The tax havens are a real problem. We do our best on this but this is an area that is an extremely difficult enforcement challenge for us.

Chairman CONRAD. Is this captured in the tax gap?

Commissioner Everson. A good bit of that would not be. We do include it if we do some high income audits and we pick something up on an individual and unravel something then you might be in there. But I would suggest a lot of it we are missing.

Chairman CONRAD. I will tell you something, I was just down in the Bahamas a few months ago. Boy, it was very interesting to read the pitch that they were making to people who might invest there and live there, very interesting. The big pitch was on taxes.

Commissioner Everson. Right.

Chairman CONRAD. You know, one of the biggest creditors of the United States now are the so-called Caribbean Banking Centers. Did you know that? We owe the Caribbean Banking Centers, as a Nation, about $100 billion. They are places like the Cayman Islands, the Bahamas.

How do they have all this money? I think we can probably figure out where some of it is coming from. But a lot of it is illegal activity. Drug dealers are funneling funds through these operations because they do not have to reveal anything or they reveal very little.

And then you have operations like this, where you have thousands of companies claiming they are doing business out of this building. They are not doing any business out of this building. They are engaged in a tax dodge because the Cayman Islands has a very favorable tax structure. That is what is really going on.

We need your help in how we go after this. So what do we do to go after this kind of thing?

Commissioner Everson. I think, sir, that supporting the budget will help us because we will be bringing up the enforcement resources and the infrastructure.

Let me say something that we did that does not get to these Caymans—I do not want to confuse the issues—but it really makes a big change. When we mandated the electronic filing for corporations, which I did at the end of 2004 for the biggest outfits, this is going to make a sea change in our ability to do analysis. A lot of this is that there is too much potential information and because of complexity and everything else how do you sift through it?

Now what we are going to do with all of this stuff that is coming in online now, starting with the last few months, we are going to be able to do much more sophisticated analysis and risk assessment that will help the compliant taxpayer. I do want you to know I do not think there is lot legitimate tax planning in the international arena. Cooperation is very important to the growth of our economy. It is good for America.

Chairman CONRAD. I do not dispute that but I am talking here about abusive—I am talking about—

Commissioner Everson. This is really tough to get at and we are working with other countries to try and have joint approaches. But some of this gets into, obviously, the conduct of tax haven countries and the laws they set up. And then our ability to understand what is going on over there is quite limited.

Chairman CONRAD. Let me just tell you, a case I was involved with when I was the tax commissioner and it involved the Cayman Islands. I found a major company that was reporting virtually no profits anywhere in the United States. But they got down to the Cayman Islands and they reported $20 million with one employee, $20 million in profits with one employee.

And of course, they paid no taxes to the Caymans either. So they structured their business to report no profits in any of their subsidiaries in the United States. They get to the Cayman Islands, all of a sudden they make $20 million where conveniently there are no taxes.

I know what is going on and there is a lot of this going on and we have to go after it.

Commissioner Everson. Yes, I agree with you 100 percent.

Chairman CONRAD. The question is let us say you collect $2.4 trillion this year. By 2010 you will be $2.5 trillion, probably more than that. And you are telling us you can do better by $20 billion. That is 0.8 percent. We have to do better than that. And you have to help us understand how we could do better than that.

What could we do to do better than that?

Commissioner Everson. What I would suggest to you, Senator, and I know Secretary Paulson feels the same way, we will work and review ideas that the Congress puts forward on all of these areas. What we are asking you to do now, meager as you might characterize these representations—

Chairman CONRAD. I accept that. I have your message on that. Let us do that. But you have to tell us—

Commissioner Everson. Let us do those and then let us see what wlse we can stomach. Because for what is more intrusive on the reporting or the withholding, these get to things that will be difficult.

FY 08 Tax Gap Legislative Proposals

Expand Information Reporting

Information reporting on payments to corporations
- Expand filing of Forms 1099 to include payments made to corporations, including S corporations

Basis reporting on security sales
- Require financial institutions (brokerage houses and mutual funds) to report customers' basis in securities sold on Form 1099

Broker reporting
- Require filing of Forms 1099 to report sales through an auction, consignment broker or exchange

Reporting of merchant payment card reimbursement
- Require payment card processors to report gross annual reimbursement to merchants - no back-up withholding requirement

Increase information return penalties

Increase amounts of penalties for failure to file information returns

TIN Verification
- Require non-employee service providers to certify accuracy of their TINs on Form W-9; as well as require TIN verification by IRS

Information reporting on certain government payments
- Establish information reporting requirements on payments for procurement of goods by the federal government

Improve Compliance by Businesses

Require e-filing by certain large businesses and exempt organizations.
- Mandate e-filing for all corporations and partnerships filing an M-3
- Applies primarily to:
  - Corporations with significant assets, but few employees
  - Large partnerships owned by corporations

Employee leasing standards
- Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes

Collection due process
- Amend collection due process procedures applicable to employment taxes to permit post-collection review.

Strengthen Tax Administration

Provide IRS with access to NDNH database
- Allow use of National Directory of New Hires data for tax administration purposes

Disclosure of prison scams
- Permit IRS to disclose to prison officials return information about tax offenses committed by inmates

Felony Failure to File
- Create a criminal felony provision for aggravated failure to file

Penalties

Expand preparer penalties
- Expand (and increase) signature requirement and related penalty provisions beyond income tax returns

Failure to file electronically
- Establish a specific assessable penalty for failure to file electronically, when required

Erroneous refund claim
- Create a penalty for negligent or frivolous claims for refund

Chairman CONRAD. And I understand that. I will tell you something, what is outrageous is the vast majority of Americans pay what they owe. The vast majority of companies pay what they owe. But we have a growing group that does not. And we cannot permit that. Obviously there is always going to be some tax gap. No system is going to be 100 percent. We understand that.

But just so people who are listening to this understand, the difference between 0.8 percent on an improvement on collection and say going to 4 percent is the difference between $20 billion and $100 billion a year. It is the difference between all the rest of us who pay what we owe having to pay more to cover for those who are not.

I will tell you this is one thing that outrages me. This kind of scam, this outrages me, 12,000 companies saying they are doing business out of this building. Excuse me? That is outrageous and unacceptable and they ought to know we are coming after them.

Commissioner Everson. It does not even look like there is a McDonald's or a retail business in there.

Chairman CONRAD. No, I do not think—you know 12,748 companies, it is amazing how efficient that building is. It is probably the most efficient building in the world. Probably the most profitable building in the world, because they are scamming. And that just cannot be allowed to continue.

We, again, appreciate your testimony and we will close the hearing.

[Whereupon, at 11:54 a.m., the committee was adjourned.]

ADDITIONAL MATERIALS SUBMITTED BY SENATOR WHITEHOUSE

SHELDON WHITEHOUSE
RHODE ISLAND

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February 14, 2007

The Honorable Kent Conrad
Chairman
Senate Committee on the Budget
Dirksen Senate Office Building Room 624
Washington, D.C. 20510-6100

Dear Mr. Chairman:

I hereby request that the attached article, "Friendly Landlord: Wal-Mart Cuts Taxes By Paying Rent To Itself," *The Wall Street Journal*, February 1, 2007, be included in the Record for the Committee's hearing on the President's Fiscal Year 2008 Budget Proposals on Tax Compliance, which took place earlier today.

Thank you for your assistance in this matter.

Sincerely,

Sheldon

Sheldon Whitehouse
United States Senator

CURRENT NEWS

Friendly Landlord: Wal-Mart Cuts Taxes By Paying Rent To Itself --- Other Retailers, Banks Use Loophole in Rules To Lower States' Levies

THE WALL STREET JOURNAL. factiva

Source: The Wall Street Journal
Date: 02/01/2007
By Jesse Drucker

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As the world's biggest retailer, Wal-Mart Stores Inc. pays billions of dollars a year in rent for its stores. Luckily for Wal-Mart, in about 25 states it has been paying most of that rent to itself -- and then deducting that amount from its state taxes.

The strategy is complex, but the bottom line is simple: It has saved Wal-Mart from paying several hundred million dollars in taxes, according to court records and a person familiar with the matter. And Wal-Mart is far from alone.

The arrangement takes advantage of a tax loophole that the federal government plugged decades ago, but which many states have been slower to catch. Here's how it works: One Wal-Mart subsidiary pays the rent to a real-estate investment trust, or REIT, which is entitled to a tax break if it pays its profits out in dividends. The REIT is 99%-owned by another Wal-Mart subsidiary, which receives the REIT's dividends tax-free. And Wal-Mart gets to deduct the rent from state taxes as a business expense, even though the money has stayed within the company.

Partly thanks to sophisticated financial strategies like these, states' tax collections from companies have been plummeting. On average, Wal-Mart has paid only about half of the statutory state tax rates for the past decade, according to Standard & Poor's Compustat, which collects data from SEC filings. The so-called "captive REIT" strategy alone cut Wal-Mart's state taxes by about 20% over one four-year period. Now several state regulators are trying to crack down on the strategy, used largely by retailers and banks, and some other states have changed their laws to try to end the practice. Yesterday, New York Gov. Eliot Spitzer included elimination of the loophole as part of his proposed budget, a fix he said would bring the state $83 million a year.

North Carolina tax authorities are challenging Wal-Mart, saying its REIT strategy was intended to "distort [the company's] true net income," according to its filings in the case in Superior Court in Raleigh, N.C. The state calls captive REITs a "high priority corporate tax sheltering issue" and in 2005 ordered Wal-Mart to pay $33 million for back taxes, interest and penalties stemming from the REIT structure. The company paid it and last year sued the state for a refund.

The structure Wal-Mart is using features some unusual elements. Because REITs must have at least 100 shareholders to gain tax benefits, roughly 100 Wal-Mart executives were enlisted to own a combined total of around 1% of the REIT's shares, without any voting rights. H. Lee Scott Jr., now Wal-Mart's CEO, was listed as the REIT's "managing trustee" from 1996 to 2004.

A single Wal-Mart real-estate official, Tony Fuller, represented the company both as tenant and landlord in its lease with itself. Ernst & Young LLP, the accounting firm that sold the strategy to Wal-Mart, also is the company's outside auditor. In its internal sales training materials, the accounting firm explicitly labeled the strategy as a method to reduce taxes -- a red flag to tax authorities, who often demand that tax shelters have other business purposes.

Wal-Mart attorneys say in court filings that the strategy is perfectly legal and that North

Carolina is exceeding its authority. A spokesman for the Bentonville, Ark., company, John Simley, said Wal-Mart "is comfortable with its current structure and is in compliance with federal and state tax laws." He added that the REIT structure was adopted to "more effectively and efficiently manage the company's real-estate portfolio, including the impact on the company's overall state tax planning."

Regulators in at least a half-dozen states are going after companies that have trimmed their taxes through similar arrangements, including Regions Financial Corp.'s AmSouth Bancorp. unit; AutoZone Inc. of Memphis, Tenn.; and two units of Bank of America Corp. In a Massachusetts case against Bank of America unit Fleet Funding Inc., authorities call Fleet's REIT arrangement a "sham" in court filings. They note that Fleet increased the salaries of the roughly 100 employees whom it made REIT shareholders to compensate them for personal income taxes stemming from ownership. The Multistate Tax Commission, an association of state revenue authorities, says it has started examining the use of captive REITs to avoid taxes, alerting states to the issue and proposing legislative fixes to close the loophole.

States collected more than $44 billion last year in corporate income taxes, out of $607 billion in total state tax receipts, according to the Nelson A. Rockefeller Institute of Government, a nonpartisan think tank associated with the State University of New York. But the average effective corporate state and local tax rate has dropped from 6.7% during the 1980s to about 5% during the first half of this decade, according to a recent report by the Congressional Research Service. This is in part because of the proliferation of state and local tax breaks, as well as tax shelters, according to several academic and government studies.

Some corporate state tax planners say arrangements like these are merely smart business, and that the loopholes exploited by companies should be fixed by state legislatures rather than litigated by state lawyers. Critics of the shelters complain they let companies use public services provided by local governments -- such as police and fire protection or new highways -- without having to shoulder their fair share of the costs. Meanwhile, the portion of state taxes borne by individuals is steadily rising.

Congress created REITs in 1960 as a way to allow smaller investors to put money in a wide portfolio of commercial real estate, spreading their risk. Congress also gave them a tax benefit: REITs aren't subject to corporate income tax on the profits they pay to shareholders as long as they pay out at least 90% of the profits. The shareholders still usually get federally taxed on the dividends, which still count as income for them.

After a boom in REITs in the early 1990s, big accounting firms including Ernst & Young and KPMG LLP figured out that on the state level, they could pair the tax break on REIT dividends with a separate tax rule that allows companies to receive dividends tax-free from their subsidiaries. With the REIT as a subsidiary itself, two rules aimed at avoiding double taxation could be combined to effectively avoid any taxation at all.

The strategy worked especially well if the REIT was owned by a company incorporated, and claiming to do all its business, in a state such as Delaware or Nevada that often wouldn't tax the corporate income anyway. That created an extra hurdle for other states to challenge the practice if they caught onto it.

Ernst & Young early on targeted the banking industry as a possible beneficiary of the captive REIT strategy. Like retailers, banks have branches in many states and often are liable for lots of state-level corporate tax. Ernst & Young targeted at least 30 banks, some of them its audit clients. The SEC generally permits that dual role as long as the firm's fee isn't contingent on the tax savings.

According to documents from a 1995 internal Ernst & Young sales training meeting reviewed by The Wall Street Journal, the accounting firm suggested banks put some of their income-producing assets, such as a portfolio of mortgages, into a REIT subsidiary, then use the double-tax break to "shelter" the income from state taxes. The REIT would issue a tiny number of non-voting shares to bank "officers and directors" to meet the 100-shareholder rule that REIT law requires.

U.S. banks "pay millions of dollars each year in state and local taxes," read the Ernst & Young presentation to its sales force. "The FSI State Tax Financial Product we have developed can significantly reduce or eliminate this heavy tax obligation . . ." One section of the Ernst & Young sales package featured hypothetical questions from clients about the REIT shelter, and the proposed answers. To pass legal muster, many corporate tax shelters purport to have additional business purposes behind merely saving taxes. Ernst & Young, however, was blunt about the reason for its proposed strategy:

"Q: What's the business purpose?

"A: Reduction in state and local taxes.

"Q: What if the press gets wind of this and portrays us as a 'tax cheat'?

"A: That's a possibility. . . . If you are concerned about possible negative publicity, you can counter it by reinvesting the savings in the community."

An Ernst & Young spokesman declined to comment on its REIT work, saying the firm was "prohibited from commenting on client matters." The spokesman said he could not verify the authenticity of the internal sales training documents based on quotes provided by the Journal. However, he said the "limited language communicated in the internal memo does not reflect the quality and nature of the advice we provide to our clients."

State authorities have had mixed records so far in pursuing back taxes and penalties in captive-REIT cases. AutoZone, the big auto-parts chain, won the right to deduct the dividends from its taxes in Kentucky but lost a preliminary round in Louisiana. The Hawaii Department of Taxation won a case involving a REIT used by Central Pacific Financial Corp., a bank holding company. AmSouth is in litigation with Alabama over tax benefits from its REIT.

Fleet Funding's REIT, on which the company was advised by KPMG, has led Massachusetts to seek more than $42 million in back taxes, interest and penalties. BankBoston Corp. is in similar litigation with Massachusetts. Both banks have been acquired by Bank of America, which declined to comment on the litigation.

Fleet's attorneys have said in court papers that its REITs were legitimate, and the fact that they were partly motivated by tax considerations does not legally undermine their valid business purpose -- to raise capital, they say. A KPMG spokeswoman declined to comment on the Fleet case, but said it had stopped any involvement with "prepackaged tax products" before a 2005 agreement it made with the U.S. Justice Department over improper tax strategies that also led to the indictment of 17 former KPMG officials.

It's unknown how many disputes have been raised over the strategy used by Wal-Mart and others, because such tax disputes are generally not disclosed unless lawsuits are publicly filed or the company reveals them in SEC filings.

Wal-Mart adopted its captive-REIT structure just as it was unwinding a previous strategy to reduce taxes that states had begun to challenge. For the first half of the 1990s, the retailer used a so-called intangible holdings company structure also used by many other corporations. Wal-Mart transferred its trademarks to a subsidiary called WMR Inc. in Delaware, which does not tax many forms of corporate income. Then it paid the subsidiary for the use of the brands. That allowed Wal-Mart to deduct those payments from its local income taxes in some states, while WMR's income wasn't taxed by Delaware.

Several states won challenges to the strategy, used by various retailers. Wal-Mart settled a dispute over its use of WMR in Louisiana -- the details of the settlement are sealed -- and lost on the main points of a case in New Mexico. Wal-Mart merged with WMR in February of 1997 and its use as a state tax avoidance vehicle was apparently discontinued, according to New Mexico court records.

In the meantime, Wal-Mart set up a new vehicle to control its state tax bill: captive REITs. In the summer and fall of 1996, Delaware corporate records show, Wal-Mart created a new hierarchy of subsidiaries: a REIT called the Wal-Mart Real Estate Business Trust; a Delaware-based parent company for the REIT, called the Wal-Mart Property Co.; and Wal-Mart Stores East Inc., parent of the Delaware firm. Wal-Mart Property owned 99% of the REIT's shares, and 100% of the voting shares, according to Wal-Mart court filings in North Carolina and West Virginia. The company also set up a similar arrangement for its Sam's Club stores.

To meet the 100-shareholder threshold required for REITs, Wal-Mart distributed a minimal amount of nonvoting stock, to approximately 114 Wal-Mart employees, according to a person familiar with the arrangement. The dividend payouts were nominal. The structure involved Wal-Mart's top executive tier. The shareholders were generally executive vice presidents and above. David Glass, then Wal-Mart's president and CEO, was listed as president of Wal-Mart Stores East on the lease agreement, and Paul Carter, then a Wal-Mart executive vice president, was listed as the president of the REIT.

Wal-Mart began transferring to the REIT ownership of the properties -- the land and buildings

-- for hundreds of its stores in 27 states, real-estate records show. Then Wal-Mart Stores East signed a 10-year lease agreement with its REIT that took effect on Jan. 31, 1997, agreeing to pay a fixed percentage of the stores'"gross sales" as rent, according to a copy of the arrangement filed in the North Carolina case. Mr. Fuller, the Wal-Mart real-estate official, is listed as the contact for both the tenant and the landlord. The original lease was due to be renewed this week.

Wal-Mart could deduct from its state-taxable income the rent paid by Wal-Mart Stores East to the REIT. The REIT paid the majority of its rental earnings to its 99% owner, Wal-Mart Property Co., in the form of dividends. That company's base in Delaware gave it another way to avoid liability for state taxes, since some states do require that dividends a REIT pays to its corporate owner be taxed, as the federal government does.

The Delaware subsidiary then paid the money back to Wal-Mart Stores East, the same subsidiary that made the payments to the REIT to begin with. Those payments to Wal-Mart Stores East weren't taxed either, because dividends paid to a corporation by a subsidiary normally aren't counted as taxable income for the parent company.

The result of the circuitous transaction: Wal-Mart could effectively turn rental payments to itself into state level tax-deductions in most of the states where the payments have been made. Under typical circumstances, rent paid to a third-party landlord also would reduce taxable income. But that would ordinarily be cash out the door, like most other tax-deductible expenses. Here, the majority of the tax-deductible rental payments came straight back to Wal-Mart.

The national tax savings have been significant. Over a four-year period, from 1998 to 2001, Wal-Mart and Sam's Club paid company-controlled REITs a total of $7.27 billion that eventually came back to Wal-Mart in states across the country, according to a North Carolina Department of Revenue auditor's report filed in court by Wal-Mart. Based on an average state corporate income tax rate of 6.5%, three accounting experts consulted by The Wall Street Journal estimated the REIT payments led to a state tax savings for Wal-Mart of roughly $350 million over just those four years. SEC filings show the company paid $1.18 billion in state taxes during that period. The loss of federal deductions that bigger state tax payments would have triggered brought the company's effective tax savings overall down to about $230 million. Wal-Mart declined to comment on the figures.

It is not clear how much Wal-Mart has paid to its own REITs in the most recent five years. The yearly rental payments -- on which the tax savings are based -- are pegged to the "gross sales" of the stores, according to the lease agreement.

Underscoring that the rental payments were cashless Wal-Mart accounting moves, an affidavit filed in North Carolina by the company's former controller, James A. Walker Jr., states that the payments were made by simply debiting the account of one subsidiary and then crediting the account of the other. "Wal-Mart Stores, Inc. served, in effect, as a bank for" both sides, the affidavit stated.

In 2005, after an audit, the North Carolina Department of Revenue issued a notice to Wal-Mart challenging the REIT structure. The state is site of about 140 of the company's roughly 3,900 U.S. stores, including Sam's Clubs. Wal-Mart paid the $33 million the state sought, and in March 2006 sued for a refund.

The company argues that the state does not have the authority to essentially combine the results of the subsidiary that did business in North Carolina with those of the Delaware-based unit and the REIT. The Delaware-based subsidiary, the company says, did no business in North Carolina and therefore was not taxable there. The company says in court filings that the REIT was qualified under federal law, that all the deductions were properly taken and that its North Carolina tax returns reflect its "true amount of net income."

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ANSWERS TO QUESTIONS SUBMITTED

Questions for the Record from Feb. 14, 2007 Hearing with IRS Commissioner Everson

Senator Sheldon Whitehouse

What legislative changes would you recommend to give IRS the authority, support or resources you need to pursue offshore tax havens?

I am proud of the work the IRS has done in this area, including the Offshore Credit Card Program, the Offshore Voluntary Compliance Initiative and the memorandum of agreement under which the Financial Crimes Enforcement Network (FinCEN) delegated its enforcement authority for Foreign Bank and Financial Account reporting to the IRS. We will continue to pursue this work to the fullest extent of existing law. At this time, the Administration has not made legislative proposals in this area. However, the FY 2008 President's Budget does include a substantial investment in improving the fairness and effectiveness of tax enforcement. The Budget seeks $410 million in new initiatives supporting enforcement programs including audits targeted on abusive offshore tax shelters.

Questions for the Record from Feb. 14, 2007 Hearing with IRS Commissioner Everson

Senator Charles Grassley

Commissioner Everson, the tax gap is not a new issue. According to the GAO, the voluntary compliance rate has changed from around 81 percent to 84 percent over the past three decades.

In the Finance Committee, we take the tax gap very seriously, because it's not fair to the vast majority of taxpayers that pay their taxes on time. We have had several hearings to examine the size, sources, and solutions to the tax gap, and we have enacted several steps to reduce the tax gap, such as boosting the IRS' whistleblower program and authorizing the private debt collection program. But we need to do more. Dozens of factors contribute to the tax gap and dozens of solutions are needed to close it. I am completely in support of taking appropriate measures to close the tax gap – and I will work aggressively toward enacting legislative change to help close it – but it has to be done with care to be effective. There are no easy solutions.

There seems to be a general consensus that potential solutions to the tax gap fall into three categories: (1) Additional and more efficient enforcement by the IRS; (2) Additional enforcement tools for the IRS, such as information reporting and withholding; and (3) changes to our tax base that reduce the complexity of our current system, including reforming or eliminating some tax expenditures, as recommended by the Joint Committee on Taxation called "Options to Improve Tax Compliance and Reform Tax Expenditures." I would note that some of the JCT staff's recommendations have been enacted, but there are many other proposals in that report that have not been enacted, such as repealing the deduction for interest on home equity loans, modifying the social security and self-employment tax rules, and moving to a territorial system for foreign business income. Others have suggested even more fundamental reform, like shifting to a consumption tax. Many of these changes, of course, would create winners and losers, making these controversial.

For Commissioner Everson:

1. **Do you agree that IRS enforcement, information reporting or withholding, and changes to the tax base are the three general categories of tax gap solutions, and how much tax gap reduction do you think is achievable in each of these categories?**

In general, I agree with your observation of three categories that have emerged from the tax gap dialogue. The Treasury Office of Tax Policy's September 2006 "Comprehensive Strategy for Reducing the Tax Gap" lists seven components, some of which roughly correspond to your three categories, including improvement of compliance activities, reduction of opportunities for evasion, and reform and simplification of the tax law. At the same time, the tax gap is a measure of tax owed but not paid under existing law, and therefore, it would not be technically accurate to categorize change to the tax base as a tax gap solution. Instead, change to the tax base would alter the amount lawfully owed.

As long as amounts owed pursuant to changed laws were paid on time, those amounts would not contribute to the tax gap.

The Treasury Strategy also includes a multi-year commitment to compliance research (to identify better ways to improve both voluntary compliance and enforcement), and for enhancing taxpayer service. Most of the types of solutions to the tax gap are inter-related. That is, addressing one area will often reinforce efforts in another area. For example, enhancing enforcement levels and information reporting are very related, since third-party information creates enforcement opportunities. One fundamental way to categorize tax gap solution strategies is: (a) efforts to reduce future tax gaps, and (b) efforts to recover past tax gaps. The latter includes mostly enforcement of the law, but a strong enforcement deterrent also reduces future tax gaps.

The Treasury Department estimates the revenue effect of specific proposed solutions (e.g., enforcement initiatives, proposed information reporting requirements, and tax law changes), but does not estimate the theoretical limits of such categories of solutions. However, it should be made clear that the IRS cannot completely eliminate the tax gap, regardless of the level of effort.

2. **On enforcement, of course JCT and CBO don't score revenue from changes in enforcement. But last year, you testified before this committee that the tax gap could be reduced by $50 to $100 billion without changing the way Government interacts with taxpayers. The largest portion of the tax gap is under-reporting by small businesses, which would seem to involve high volume and low dollars. So I find it hard to believe that going after the bulk of the tax gap with IRS enforcement would not result in a much more intrusive IRS.**

In my testimony, I stated that $50 to $100 billion per year was my own feeling as to how much we could reduce the tax gap (through a balanced strategy of tax simplification, enforcement, and taxpayer service) <u>without changing the fundamental relationship between taxpayers and their government</u>. That is, beyond that point (certainly under the current tax system), the "solutions" would become too draconian for the public to support. I have not advocated an enforcement-only approach. However, there is much room to expand enforcement cost-effectively and non-intrusively when done in conjunction with enhanced taxpayer service and smart legislative changes. For example, in 1990, IRS field examiners audited about one percent of all returns filed by non-farm sole proprietors. In 2005, they audited barely over half of that percentage. The IRS has begun to reverse the trends in declining coverage, but can do more.

Is your $50 to $100 billion figure on top of the $55 billion that the IRS includes in its net tax gap estimate of $290 billion? In other words, have you already gotten a lot of the $50 billion you spoke of last year through direct and indirect enforcement efforts?

My estimate is related to how much *more* we could reduce the net tax gap, so it would be in addition to the $55 billion. However, much of it would come in the form of increased voluntary compliance, not just enforcement revenue.

Questions for the Record from Feb. 14, 2007 Hearing with IRS Commissioner Everson

Senator Wayne Allard

1. **Please describe all IRS enforcement efforts targeted at the collection of small amounts, such as those under $100. How much does the IRS spend on programs to collect said amounts? For every dollar spent on those programs, how much does the IRS get in return?**

The IRS will not likely ever have sufficient resources to work every balance due case. Therefore, there must be a process to select and prioritize cases. The IRS' collection strategy places priority on rapidly working the largest number of cases with the highest potential risk to future compliance. All new cases above a minimum liability receive some form of collection treatment and we provide contact options in Campus, Field, and electronic environments to maximize opportunities for early resolution for all taxpayers.

Generally, for diminutive balances dues, subject to certain thresholds, a taxpayer will receive the first notice, as required by statute. The IRS may defer the balance due and subject it to future "passive" collection efforts, such as refund offsets, which the IRS administers systemically. However, if one of these accounts continues to accrue liabilities, it would potentially be subject to additional scrutiny as the compliance risk increases.

The IRS does not stratify dollars collected or costs for unpaid assessments less than $100. Instead, the IRS provides enterprise-wide calculations, as noted in the answer the Question 2.

2. **I understand that the IRS has contracted with private collection agencies to collect undisputed tax debts under $25,000. What is the rate of return, including the cost of IRS employees' time, to the IRS on these private collection efforts? What is the rate of return on the IRS's own collection efforts for amounts under $25,000? What is the overall rate of return on all IRS enforcement efforts?**

Overall, the IRS Return on Investment (ROI) is about 4 to 1. ROI resulting from IRS enforcement programs ranges from $3 to $14 for every additional $1 invested, depending on the type of enforcement activity. For example, labor-intensive activities such as the Collection Field Function have lower ROIs, and automated activities such as Automated Underreporter have high ROIs. The IRS does not stratify dollars collected or costs for unpaid assessments less than $25,000.

For the Private Debt Collection (PDC) program specifically, the potential return is between 3.2 to 1 and 3.6 to 1 for FY 2007, the first full year of implementation. This estimate is based on FY07 gross revenue of $45.7M - $65M, divided by the operating costs of the program, which include payments to Private Collection Agencies (PCAs) averaging 18.5% of gross program revenues and fully loaded projected FTE costs of

\$5.99M[1]. Please note that the cases assigned to PCAs are now limited to those with balances due under \$100,000, not \$25,000.

In FY08, the IRS expects the PDC ROI will increase to between 4.0 to 1 and 4.3 to 1, once the program is in steady state. The IRS bases this estimate on FY08 gross revenue projections of \$86M - \$127M compared to operating costs of approximately \$5.84M in IRS costs and the average 18.5% payments to the PCAs.

3. **Last November, I wrote to you asking for specific information regarding the IRS audit process of conservation easements in Colorado. I indicated the donors of Colorado are currently being subjected to a higher level of scrutiny compared to others across the country. If illegal activities are being discovered, then the higher level of scrutiny is warranted. Can you give me an update on the on-going audit process of conservation easements in Colorado?**

In examining conservation easements in Colorado, and elsewhere around the country, we are addressing one part of a larger problem of taxpayers taking deductions based on inflated valuations of real property interests and other non-cash items donated to charity. We are examining returns throughout the country. In Colorado, the Department of Revenue asked us to assist them in a review of issues relating to conservation easements.

Colorado's Department of Revenue initially identified over 5,000 transactions where taxpayers claimed a state-authorized conservation easement donation credit. By the time we wrote to you on December 28, 2006, our review of these transactions had identified 250 returns with potential Federal tax issues. Since then, the number of returns under audit has increased to 290 returns. The number of returns has increased because, in accordance with our usual practice, we often open additional years when we find a problem with a taxpayer's return for one year. We are making good progress working the Colorado conservation easement cases, and have either closed or delivered a revenue agent report (RAR) with respect to 22% of the returns.

We have found evidence of abuse in some cases. The IRS, of course, needs to address this abuse, and cases involving abuse take time to develop properly. We have found a variety of problems, including abuse of the quid pro quo rules (e.g., a builder grants an easement in order to obtain a building permit); inflated valuations that often are based on unrealistic assumptions; and easements that have not been granted in perpetuity as required by section 170(h) of the Code.

A significant number of open returns in Colorado involve only the issue of the correct valuation for the donated easement. Since January we have been working on ways to resolve these cases expeditiously.

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[1] *The \$5.99Min FY07 and \$5.84M in FY08 FTE costs includes labor, benefits and non-labor costs incurred by the PDC program office, PDC project team, and support provided from Counsel, Small Business Self-Employed Finance, Procurement and Taxpayer Advocate Service. It also includes costs for performing background investigations and contractor support for the PDC Business Team. This does not include Information Technology (IT) system development and maintenance costs.*

4. Local IRS agents in Colorado have been using the *Glass v Commissioner* case to determine whether or not conservation easements are deemed qualified. On December 21, 2006, a federal decision struck down – for the second time – the *Glass* decision. How has the IRS investigation changed in light of the *Glass* decision?

In the case of Glass v. Commissioner, 471 F. 3d 698 (6^{th} Cir. 2006), we challenged a claimed deduction for conservation easements in Michigan. The Tax Court held that the conservation easements were deductible; we appealed the Tax Court decision, but the Sixth Circuit Court of Appeals affirmed.

The issues in the Glass case were largely factual. We questioned whether the taxpayer's easement did protect "a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem," as required by the statute, and whether the taxpayer complied with the "exclusively for conservation purposes" requirement under the statute in light of the reserved rights that he retained--rights to alter trees, construct foot paths and decks, patios, or boat houses. Our concern was whether the rights retained by the taxpayer were consistent with the taxpayer's stated conservation purpose.

We did not at any time argue that the only way to satisfy the conservation purposes test is to have endangered species on the property. The statute clearly contemplates that taxpayers may meet the conservation purposes test in a number of ways.

The Sixth Circuit's opinion in Glass did not challenge the underlying statute or regulations. Because the Glass case is based on scientific facts unique to the case, it has not changed the way we evaluate most cases.

Subsequent to the Tax Court case in Glass, we litigated the propriety of a claimed deduction for a conservation easement in Virginia in the Turner case. This case (Turner v. Commissioner, 126 T.C. 299 (2006)) focused on the open space conservation purpose rather than the natural habitat purpose that was the issue in Glass. The Tax Court agreed with us in Turner and issued a favorable opinion.

5. What specific guidance is the local IRS using to evaluate whether a conservation easement has "conservation purpose"?

The Internal Revenue Code, the regulations and the case law provide the guidance we use, not only in Colorado but throughout the country, in an examination to determine the meaning of "conservation purpose."

The Internal Revenue Code clearly contemplates that taxpayers may meet the conservation purpose test in a number of ways. The presence of an endangered species has never been a requirement for a conservation easement, although it is a factor that can help demonstrate the existence of a conservation purpose in a case involving "relatively natural habitat." To clarify some confusion on this issue in Colorado late last year, we took steps to ensure that our employees knew and were correctly applying the law. In addition, the Office of the Chief Counsel issued an information letter dated December 18, 2006 clearly stating the law. The Land Trust Alliance gave the letter wide publicity by posting it to the LTA website.

6. What properties are IRS engineers using as "comparable values" in their valuation assessments?

The value of a contributed conservation easement under § 170 of the Internal Revenue Code is its fair market value at the time of the contribution. The IRS instructs its engineers that if a substantial record of sales of easements comparable to the donated easement exists, then the fair market value of the donated easement is based on the sales price of the comparable easements. However, there is usually no substantial record of sales available for use as a meaningful or valid comparison. Accordingly, as a general rule, IRS engineers determine the fair market value of a conservation easement with reference to the difference between the fair market value of the real property before the granting of the easement and the fair market value of that same real property after the granting of the easement. Thus, IRS engineers need to review the value of the land at two different points in time--before the easement was granted ("before value") and after the easement is granted ("after value"). For the "before value," the engineers look to sales of comparable property not encumbered by an easement, and for the "after value," the engineers look to sales of comparable property that is encumbered by an easement. The engineers take into account the unique characteristics of the real property as well as the specific terms of the deed of conservation easement.

Questions for the Record from Feb. 14, 2007 Hearing with IRS Commissioner Everson

Senator John Cornyn

Mr. Commissioner, I would like to get a better handle on your agency's costs.

I would appreciate specific answers to these questions. As they say, I am not interested in your "big numbers." Rather I am interested in the marginal cost of adding an additional field function person to the Internal Revenue Service.

1. **Can you tell me what the average salary (including locality pay and bonuses) for the approximately 3,680 field Collection Field function staff---so called collection officers? My understanding is these folks are the heart of your collections operations.**

The average salary in FY 2006, excluding awards, for Small Business/Self Employed (SB/SE) Revenue Officers was $70,271. We do not track Revenue Officers' awards separately from other positions in the Collection function, but the average award given to employees performing Collection work was $1,131 in FY 2006.

2. **Please tell me the average cost for employer-paid benefits and taxes for these same folks (including employer contributions to Social Security, both FICA and Medicare, Federal Employee Group Life Insurance, Federal Employee Health Benefit, Federal Employees Retirement System, Civil Service Retirement System, and Thrift Savings Plan).**

The average benefit cost for SB/SE Revenue Officers in FY 2006 was $16,920.

3. **Finally, I would appreciate the average cost for direct overhead, including the cost of management and supervision, support staff, rental payments, office equipment and furniture, travel, data processing services, vehicle costs, utilities, telecommunications, postage, printing and reproduction, supplies and materials, land and structures, insurance claims and indemnities, et cetera.**

The average non-labor and corporate overhead costs, not included in questions 2 and 3 above, for SB/SE Revenue Officers in FY 2006 was $16,808. This amount includes travel, supplies and other non-labor support costs associated with performing collection work as well as corporate costs such as rent, worklife programs, and computer hardware, software and maintenance. It does not include management and supervision costs. The IRS is in the early stages of developing a methodology for using cost data from the Integrated Financial System (IFS) to calculate the unit costs for its key products and services.

THE PRESIDENT'S DEFENSE BUDGET REQUEST FOR FISCAL YEAR 2008 AND WAR COSTS

THURSDAY, MARCH 1, 2007

UNITED STATES 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, Lautenberg, Nelson, Menendez, Gregg, and Allard.

Staff present: Mary Naylor, Majority Staff Director, Scott Gudes, Staff Director for the Minority.

OPENING STATEMENT OF CHAIRMAN KENT CONRAD

Chairman CONRAD. The committee will come to order. I would like to welcome everyone to today's Budget Committee hearing on the President's defense budget and requests for additional war funding. Our witnesses today are Gordon England, the Deputy Secretary of Defense; Admiral John Giambastiani—I hope I pronounced that right.

Admiral GIAMBASTIANI. He did great, sir, thank you.

Chairman CONRAD. OK. As I have told you, my wife is Italian, as well.

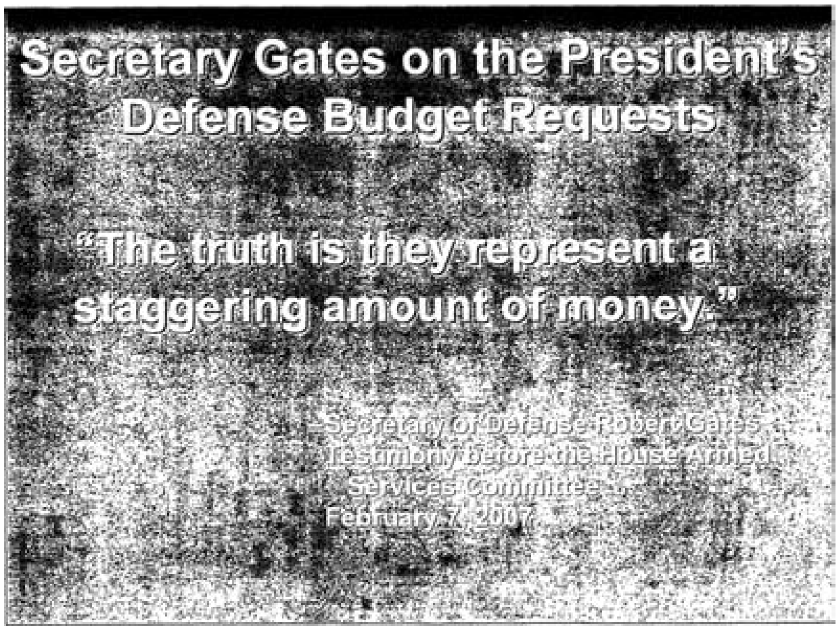
Vice Chairman of the Joint Chiefs of Staff. Ms. Tina Jonas, the Under Secretary and Comptroller of the of the Department of Defense. We appreciate very much all of you being here.

We all know that Secretary England serves as the Chief Operating Officer of the Department of Defense and was previously the Secretary of the Navy.

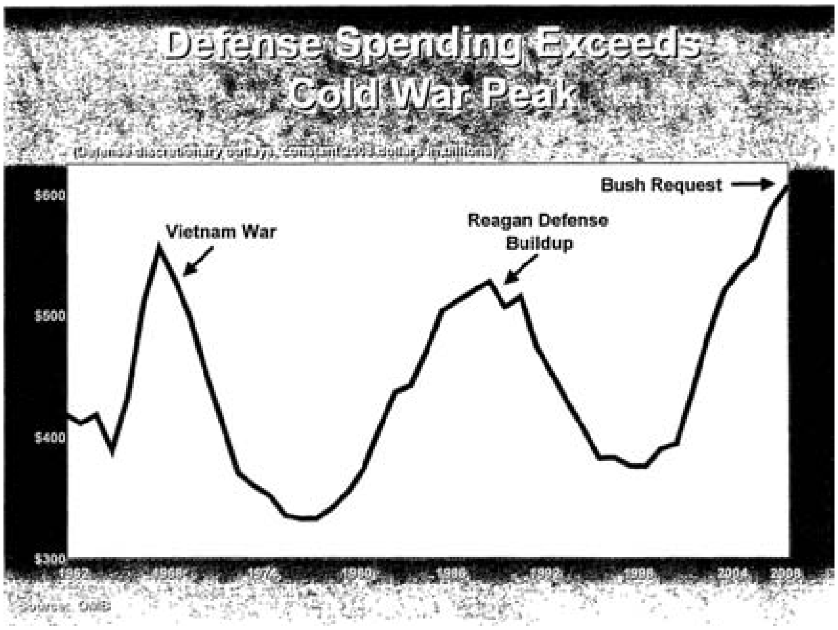
Our witnesses today are all dedicated public servants and we very much appreciate not only their service to the country but their being here today.

I wanted to be clear, the Budget Committee is disappointed that Secretary Gates was not able to testify here. We hope that he will testify before this committee later this year, and the committee feels strongly about that issue and we want to make certain that that is communicated.

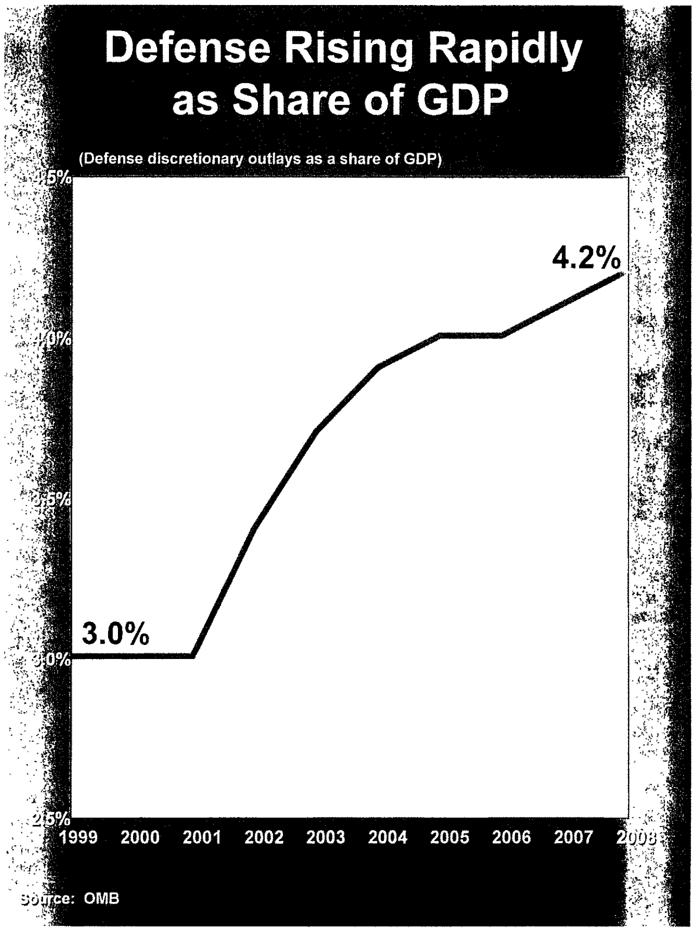
The defense budget represents the single largest area of discretionary spending. Secretary Gates has acknowledged the magnitude of the President's defense request. He recently stated "The truth is they represent a staggering amount of money." Certainly that is the case. We also want to put in context, in terms of our overall budget, what these costs are as a share of our gross domestic product. We will get that momentarily.



To put the defense request in some historical perspective, we can see that under the President's request defense spending for 2008 will exceed the highest levels during the cold war. We will spend more then at the peak of the Vietnam War or the peak of the Korean War, even after adjusting for inflation. And defense spending has been rising rapidly as a share of GDP, from 3 percent in 2001 to 4.2 percent in 2008.

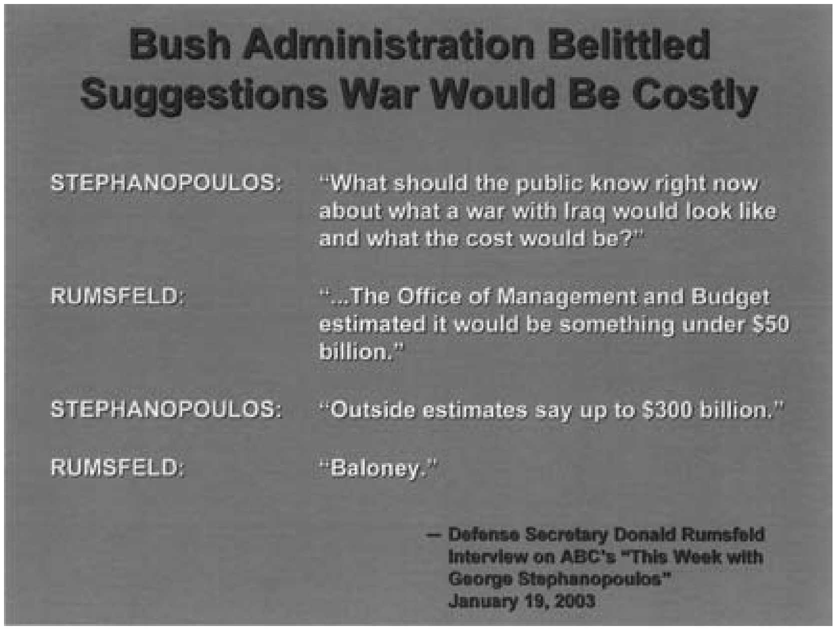


Now as a share of GDP, we are not at a historic peak or anywhere close to it. So I think it is very important to understand both points. On a dollar basis, inflation adjusted, we are at a peak compared to those previous time periods. But as a share of GDP, we are nowhere close to a peak. And I think it is important for people to understand both of those facts.



The costs of the war in Iraq are the major factor driving our defense expenditures higher. It is worth noting that before the Iraq War began, the Bush Administration suggested that this war would not be this costly. Here is a transcript of an interview with the previous Secretary of Defense on This Week With George Stephanopoulos.

Stephanopoulos asked "What should the public know right now about what a war with Iraq would look like and what the cost would be?"



Secretary RUMSFELD. "The Office of Management and Budget estimated it would be something under $50 billion."

Stephanopoulos: "Outside estimates say up to $300 billion."

The Secretary "BALONEY." well, now we know that the $300 billion cost estimate was not baloney, it was actually too low. CBO now estimates the war cost is approaching $532 billion. That is what has already been appropriated and what has been requested. That is, of course, on top of the regular defense budget. That brings the total cost of the Iraq War close to what we spent in Vietnam over 12 years, even adjusting for inflation.

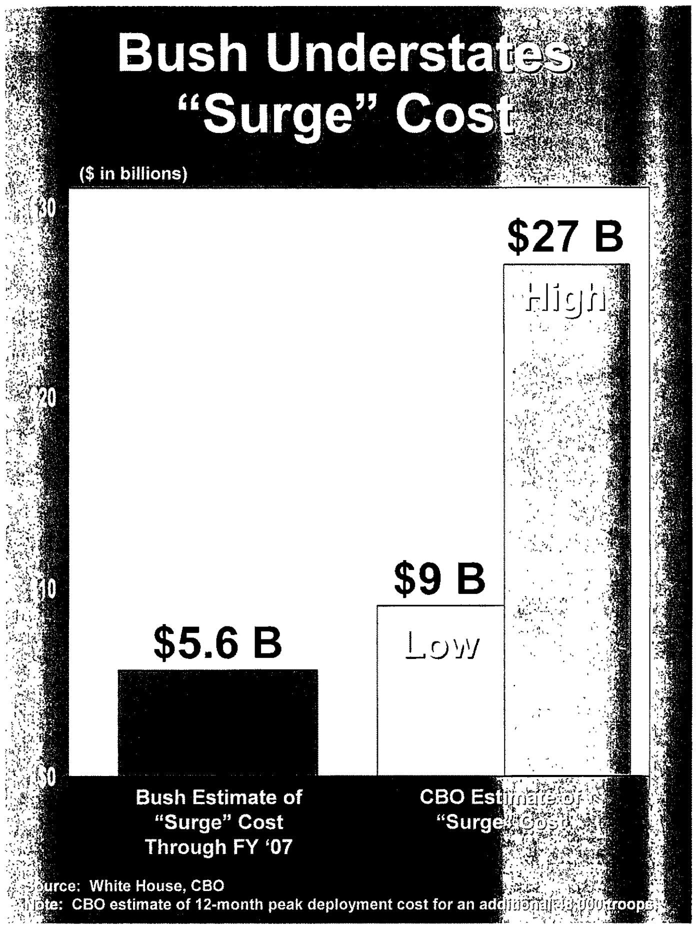

Iraq War Costs Exceed
Half a Trillion Dollars
($ in billions)
$532 B
$50 B
$0
Bush Administration
Original Iraq War
Cost Estimate
Total Iraq
Appropriations
and Requests
Source: OMB, CBO, and SBC Democratic staff

And that is not going to be the end of these costs. The President's budget includes a request for $145 billion for 2008, a partial plug as they call it of $50 billion for 2009, which we do not believe is realistic.

While that is more realistic than previous Bush Administration budgets, it is still, we believe, underestimating the likely ongoing costs.

Let me stress, this is not just with respect to the war in Iraq. This also involves the war in Afghanistan and the overall war on terror. I have found many times in the press reports, they collapse it all down to just be the war in Iraq. That is not the case. I think it is very important for people to understand. Even if the war in Iraq were to end relatively soon we would still, in all likelihood, have ongoing costs certainly in Afghanistan, I believe, and in the ongoing war on terror.

Let me get into another issue that has been of concern to the committee, and that is the estimate of the costs of the surge—or whatever one terms it—with respect to putting the additional troops into Iraq. The Administration indicated that the cost would be $5.6 billion but the Congressional Budget Office estimated that the surge could actually cost $9 billion to $27 billion because the Administration was not fully accounting for the cost of all the support troops. CBO says that achieving a surge of 20,000 combat troops will actually require 35,000 to 48,000 total additional personnel, once you count all the support troops that are required and support units.



This committee held a hearing on the issue and we found CBO's analysis to be quite compelling. We would be interested in exploring that after the testimony of our witnesses today.

Let me close with one more important point, and Senator Gregg and I strongly agree on this. Until this year the Administration has not been financing the war through the regular budget process, but instead through a series of supplemental appropriations bills on an emergency basis. We strongly urged the White House to put these war costs in the regular budget process. And to their credit, and

I think actually very much to the credit of Senator Gregg, they did increase quite dramatically what they put in the budget. But it is still done on an emergency basis, and that troubles us, in terms of the regular order here and having the disciplined oversight that we think is critically important to making certain dollars are not wasted. When we are spending over $10 billion a month, we think it is critically important that Congress conduct responsible oversight and look at all of our fiscal obligations.

With that, I would like to turn to the distinguished ranking member, Senator Gregg.

OPENING STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Thank you, Mr. Chairman, and we thank the panel for appearing today. Thank you, Admiral, and thank the Secretary and Comptroller Jonas for taking the time to go before the Budget Committee.

Yesterday or the day before yesterday we had the Chairman of the Joint Chiefs and the Secretary of Defense before the Appropriations Committee. A lot of interesting issues were raised but I think there are points which need to be addressed here which I would like to highlight and then hopefully we can get into them in more specifics.

The first I will pick up, not necessarily in order of priority, but first picking up on the last statement by the Chairman, is the continued financing of the war in a manner which is outside the budget process. Declaring the funding for the war to be an emergency is really no longer a defensible position, because clearly we know we have these costs and obligation in this war now, after 5 years. And we certainly understand that we are going to be engaged in it for some time to come. And these costs should be predictable to a large extent. To the extent they are not predictable, they would be at the margin and could come up in an emergency supplemental. But the vast majority of the costs are clearly predictable.

So these should not come forward as an emergency supplemental. I do not have any problem with them coming forward in what I call a "sidecar", where they are essentially not folded into the base of the basic defense budget, the war costs, and I do not think they should be. Because hopefully two or three or 4 years from now, when we are disengaged completely, hopefully, from Iraq we do not want to have to sift these accounts out. But they should no longer be declared an emergency and, in my opinion, the emergency designation should be stripped from the supplemental.

Also the supplemental process, the emergency supplemental process, is being used to shield spending which is clearly not part of the war effort, in my opinion, and is being used as a way, because money is fungible, to basically bump up the base budget and put accounts into the emergency exercise which should be properly reviewed as part of the basic defense budget.

I would take, for example, in the supplemental we have pending before us, there is an Osprey proposed which is not part of this war effort, will not be on line in time for the war effort. There are five C–130Js, which again probably will not even get to the theater. There are eight E–18 Growlers. There is a permanent force structure increase which again, is not part of the war effort. It is part of reorganizing the core element of the Marines, clearly. And there are even two Joint Strike Fighters in this budget, in the supplemental. They will not even be completed until 2013.

I suppose it is human nature, when you have a vehicle moving you know you are going to get through, to try to load it up. Regrettably, some of my colleagues are throwing baggage on this train which has nothing to do with the war effort or emergencies, also. But it is one of the problems of sending this up through an emergency process.

Those programs that I just outlined should go through the authorizing process, should go through the authorizing committee and then come to the Appropriations Committee in the regular order. They should not be set outside the process. So that concerns me.

Those are concerns of significance, but I think the bigger concern is where our costs of defense are going. There is no question that the first responsibility of a government, especially our government, is to defend our Nation. We have an obligation. But we are seeing an explosion of cost here in the core defense budget which is very significant, and that is not necessarily related to the war effort. Or if it is related to the war effort, then it is projecting the war effort to go on for a lot longer than I hope it will go on, relative to the Iraq situation.

For example, the Select Acquisition Report, which basically reflects what the Defense Department needs to buy, in 2001 was projecting weapons systems that would cost us about $790 billion. The Select Acquisition Report for 2005 is projecting acquisition costs of $1.5 trillion. So it has more than doubled in 4 years. That is a big jump. One wonders whether we can afford that sort of pace of expansion in those types of accounts.

There are other issues which concern me. In the statement from the Secretary today, the statement is made that Iran, North Korea, and China, in different ways, are currently the most worrisome concerns. In my opinion, al Qaeda is the most worrisome concern, and the threat of a terrorist attack on American soil using a weapon of mass distraction is our greatest threat. These other nations are obviously significant concerns, and certainly a nuclear Iran is a very significant concern.

But it does seem to me that if the mentality of the defense structure is that we are basically focused, as our primary concern, on those three nations in the traditional war fighting balance of power structure, that we are missing the point that we are now engaged in an entirely different world where boots on the ground do not necessarily win the fight. Intelligence and the capacity to find the people before they attack us wins the fight. The people who want to attack us are not organized in nation-states, they are just very organized as religious fanatics.

And so I am interested in knowing how the Department of Defense reviews the balance between those two issues of confronting nation-states and confronting a very orchestrated, very large, religiously fanatically—a group of religious fanatics who believe genuinely that they should destroy our Nation and our culture.

These are just some questions I have and I look forward to hearing from the Secretary on these. But let me end my statement by saying that I greatly admire the service that you folks give our Nation. I think we all do, obviously. We appreciate it. We know you are in difficult times and having tremendous stress on you, as individuals, and obviously on the people you serve with who are in harm's way. And we thank you their service and your service.

Chairman CONRAD. Thank you, Senator Gregg.

Secretary England, why don't you proceed with your testimony.

STATEMENT OF HONORABLE GORDON ENGLAND, DEPUTY SECRETARY, DEPARTMENT OF DEFENSE, ACCOMPANIED BY ADMIRAL EDMUND P. GIAMBASTIANI, JR., VICE CHAIRMAN, JOINT CHIEFS OF STAFF, DEPARTMENT OF DEFENSE, AND TINA JONAS, UNDER SECRETARY OF DEFENSE (COMPTROLLER), DEPARTMENT OF DEFENSE

Mr. ENGLAND. Mr. Chairman, thank you very much. Senator Gregg, thank you for the comments.

We do have a written statement which has been turned in and I am just going to make a few comments because I would much rather discuss what is on your mind.

Mr. Chairman, I am sorry the Secretary is not here. You sort of have the backup quarterback today. But hopefully I can provide some useful information for you that will help in your deliberations and certainly we will try to do so.

I would comment, first, lots of views about America and our defense of America. But I do know this. Everybody knows that we need to protect and defend our freedoms and our liberty. So while people may have different views on how to do that, I am encouraged that everybody is debating the core about how is the best way to do that. And we do that to the very best we can. And we are blessed, as you said, to have these magnificent men and women who serve our Nation every day.

My job and the job at the other people in the Department of Defense is to provide them the equipment and the training and everything they need to carry out that mission for America.

I am pleased to have my good friends and coworkers with me, the Vice Chairman, Ed Giambastiani, Admiral Giambastiani; and also the Comptroller, Ms. Tina Jonas. We work together every day, so hopefully we can be helpful together in providing you some information today.

The Secretary was absolutely right, it is a staggering amount of money. We understand that. The total request before the Congress is $716 billion and it is three pieces. It is the supplemental, it is the 2008 base budget, and then it is also that 2008 what we called GWOT, which is the Global War on Terror amount.

I understand the comment about why is it a supplemental and not in the base budget. Of course, that is a decision, first, of OMB, not the Department of Defense. But this year we did turn in with the 2008 budget, at the request of Congress, our best estimate of what the war costs would be in 2008. And I will tell you—the dilemma we are always in, and we had this discussion last year. If we do a supplemental, it is very near term, in terms of the estimates are much better. If we look out further they become less predictable.

So when we put the numbers together for 2008 we basically took a projection of 2007. So not knowing if it goes up and down, we just took where we were in 2007 and pretty much straight-lined that in terms of the number of troops and the cost of war. And so the expectation will be, frankly, that that number will change as we get closer and know more about what is happening on the ground. And it could go up or down, depending on what the situation in Iraq is. But it was the best we could estimate for the 2008 period.

The 2007 supplemental, of course, is more near-term to us, so hopefully it has a higher degree of fidelity.

In terms of what is in the supplemental, we provide extensive detail, more than I think we have ever provided, and as much as we provide for the budget itself. So we provide all of the supporting detail, how many thousand pages? I mean, 30,000-some pages in support. So we have provided a lot of information in support of it. And obviously we are pleased to discuss that whatever detail members of the committee would like to discuss that.

Mr. Gregg, we do try to limit this to war costs. Your comment about the airplanes, I mean here again is the issue we have with this: we look at what has been lost as a consequence of the war itself or what I will call the accelerated depreciation of assets. So if we are flying airplanes a lot during the war and the life is getting very short on those airplanes, just like any other enterprise, we try to recover that depreciated cost.

And then we buy whatever it is that we are buying. So those airplanes, a lot of what is being lost is no longer in production or those models are no longer available. So we buy whatever is in production. And they may not show up immediately. But if we do not replace them, at some point we will be short those assets.

So this is, frankly, recovering the cost of using the assets for the war, whether they are lost or just being used up, recovering that cost and then applying them to whatever it is that is already being bought at that point in time. If we do not do that, then we will be short in the future. The war costs will eventually just consume our assets. So frankly, I do not see that we have any choice in how we do that.

But we do religiously go through this. Our analysis people go through all of the war data, all of the operational rates, all of the burn rates, et cetera. And we only include in the supplemental those things that we can directly relate to the war.

So hopefully, that is some feedback in terms of how we got to where we are today.

With that, I will stop. Because frankly I would much rather discuss what is on your mind this morning. You already have our written statement and obviously you are quite familiar with the budget we submitted.

[The prepared statement of Mr. England follows:]

Statement of the Honorable Gordon England
Deputy Secretary of Defense
Before the Senate Budget Committee
1 March 2007

Chairman Conrad, Senator Gregg, Members of the Senate Budget Committee,

Thank you for the invitation to discuss the defense budget requests. And thank you for your continuing support for all of our men and women in uniform and their civilian counterparts. We all share a common objective – to protect and defend America, and to prepare the men and women of the Department of Defense to help do so.

The Vice Chairman of the Joint Chiefs of Staff Admiral Giambastiani and the Under Secretary of Defense (Comptroller) Ms. Jonas are here with me, and the three of us look forward to your questions.

CONTEXT AND VISION

When authorized, the defense budget request will provide our joint warfighters with what they need to accomplish their mission of protecting and defending America – our land, our people and our way of life. The mission is to defeat terrorists, protect the homeland, and deter and if necessary defeat future threats. Iran, North Korea, and China – in different ways – are currently the most worrisome concerns.

It is important not to lose sight of the long-term strategic picture while we prosecute the current war. The Department still requires systems to deter or dissuade possible future threats. It is a lot less expensive to deter and dissuade, than to fight and defeat. It is important both to fund near-term tactical expenses and to invest in long-term deterrence, or the nation will be at risk. Finding the balance is – as always – a challenge for the Department and for the Nation.

The budget requests currently before you will achieve the following things:

- Make the necessary strategic investments to modernize to meet current and future security challenges and to recapitalize joint warfighting capabilities;
- Sustain the all-volunteer military by increasing ground forces, reducing stress on the force, and improving the quality of life for our servicemembers and their families;
- Improve readiness throughout the force through additional training and maintenance, and more timely force reset after deployment;
- Enable the United States and partner nations to achieve success in the war on terror – in Iraq, in Afghanistan, and around the world.

BUDGET REQUESTS

There are three requests before the Congress. The President's request for Fiscal Year 2008 includes the base defense budget request for $481.4 billion and $141.7 billion to fight the Global

War on Terror. The FY 2007 Emergency Supplemental Appropriation Request for the Global War on Terror is $93.4 billion. The total request is $716.5 billion.

These numbers are undoubtedly large. They exceed the defense spending of America's closest allies – and the entire GDP of many of our close partners. But they also reflect the realities and responsibilities of this Department – what is required to adequately protect and defend America, now and in the future.

Let me first describe the "theory of the casc" for using these three categories, then review what each of the requests buys the nation in terms of security and defense.

CATEGORIES

In general, the base budget funds the Department's mission to "man, organize, train and equip" America's armed forces. The basc budget captures and balances the costs of sustaining the force, with the costs of investing in capabilities needed to meet emergent security challenges.

Supplementals, in turn, have been used to finance the ongoing costs of contingency operations, including costs of the global war on terror. Iraq- and Afghanistan-related costs account for most of the total. One helpful way to think about this category is that it includes "emergency" costs, brought about by the current war effort, which the Department would otherwise not have had at this time.

In Title IX of the FY 2007 DoD Appropriations Act, Congress appropriated $70 billion in emergency funds to the Department. One of the budget requests now before you is the Department's FY 2007 Supplemental Request, to continue to support war-related costs for the rest of the current fiscal year.

In FY 2008, the approach is somewhat different. In the National Defense Authorization Act for Fiscal Year 2007, the Congress directed the President to submit the full-year costs of ongoing operations in the war on terror in the defense budget.[1] Accordingly, the Global War on Terror Request for Fiscal Year 2008 is being submitted as part of the defense budget. Substantively, it covers the same kinds of requirements addressed in previous supplementals. Since it addresses the inherently changeable circumstances of war, accurately predicting requirements is difficult, so the Department has used projections based on current monthly war costs.

WHAT THE BASE BUDGET BUYS

Broadly, the base budget breaks down into several major categories – balanced between people and equipment, and between current and future needs. For 2008, those categories, and their amounts, are:

[1] Pursuant to Section 1105.

Readiness and support[2] ($146.5 billion)	30%
Strategic modernization[3] ($176.8 billion)	38%
Military pay and healthcare[4] ($137 billion)	28%
Facilities[5] ($21.1 billion)	4%

This base budget request includes an increase of $49.4 billion over the enacted budget for FY 2007. Some of the top priorities are as follows:

The Department's top priority – and our greatest asset – is our people. America continues to be blessed that in every generation, brave men and women have stepped forward to serve a cause higher than themselves. The Department responds by continuing to support a high quality of life for our servicemembers. Almost one-third of the base budget is allocated to taking care of our men and women in uniform, and their families.

The Department's success in this regard is reflected in the Services' ongoing ability to meet recruiting and retention goals.[6]

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[2] Readiness and support is about the ability to provide warfighting capabilities whenever and wherever the nation needs them: Readiness $65.9B; Base operations and recruiting $59.9B; Maintain equipment and buildings $18.2; Commissaries $2.5B.

[3] Strategic modernization is based on a long-term view of the capabilities required to succeed against current and possible future adversaries: Navy and aircraft $62.4B; Aircraft and satellites $50.9B; Ground capabilities and support systems $37.8B; Research and development to include science and technology, and chemical and biological defense $16.8B; Missile Defense Agency $8.9B.

[4] The military pay and healthcare category is about taking care of our military and their families. It includes pay for the 1.3 million Active Component and 0.8 million Reserve Component members $98.3B; and one of the best health care systems in the world, for military and dependents $38.7B, which reflects a $-1.9B adjustment for anticipated savings for DoD's sustaining benefit proposal.

[5] Facilities costs include: Family housing $2.9B; BRAC implementation $8.4B; Operational and training facilities, troop housing, and base infrastructure $9.8B.

[6] **AC Recruiting:** All 4 Services met or exceeded recruiting goals throughout FY 2006, and have continued to do so through January 2007. AC recruiting as a % of goal, over time:

	FY2006	Oct 2006	Nov 2006	Dec 2006	Jan 2007
USA	101	108	105	123	111
USN	100	100	100	100	100
USMC	100	101	104	110	108
USAF	100	100	100	100	100

RC Accessions: In Jan 2007, 4 of 6 components exceeded their goals:

	FY2006	Oct 2006	Nov 2006	Dec 2006	Jan 2007
ARNG	99	123	113	119	101
USAR	95	98	79	102	99
USNR	87	87	91	80	93
USMCR	100	102	102	104	102
ANG	97	117	115	105	103
USAFR	106	100	100	105	103

AC retention: In January 2007, AC retention was solid – USAF and USMC are meeting or exceeding overall retention missions. USA is exceeding its year-to-date mission; while USN met 93% of its mission.

RC attrition: For the most recently available month, December 2006, attrition in all reserve components was well within acceptable limits – as it has been since at least the beginning of FY 2006.

Though not directly reflected numerically, recent policy changes concerning the use of the Guard and Reserves will allow servicemembers more predictable mobilization schedules – and more time with their families – also directly improving quality of life.

New in this budget request is support for increasing the permanent endstrength of the Army and Marine Corps. Recently, the President announced the plan to increase the total ground forces by 92,000, by FY 2012. The Army will grow from 482,400 to 547,400, and the Marine Corps from 175,000 to 202,000. The Department adds $12.1 billion in the FY 2008 base budget to support the first step – an increase of 7,000 Soldiers and 5,000 Marines. Based on a continuing need for military forces, the endstrength increase will improve the ratio of time spent deployed versus time at home, in turn reducing stress on individuals and families.

The increase in requested funds to improve readiness and support – $16.8 billion more than enacted for FY 2007 – reflects lessons learned from current engagements about the changing nature of warfare and the need to be better prepared for it. Almost half of the requested increase will support training – increased full-spectrum training; combat training center rotations; sustained air crew training; and increased steaming days for ships.

The increase in funds for readiness and support will also support the Department's move toward greater net-centricity – a system of networks and approaches designed to make information available to whomever needs it, wherever they are, in real time. This is an integral part of the Department's approach to 21st century warfighting.

The single largest category in the base budget request is strategic modernization – making sure the Department has the weapons systems needed, in every domain – ground, air, maritime, space and cyberspace – to meet the full array of emerging security challenges. Major investments in these domains, in FY 2008, include:

- Future Combat Systems ($3.7 billion): FCS, including unmanned aerial vehicles, manned and unmanned ground vehicles, and other linked systems, is the Army's first comprehensive modernization program in a generation. This is the Army's way forward.
- Joint Strike Fighter ($6.1 billion): This international program provides the next-generation strike aircraft in three variants designed to meet the different needs of the Air Force, the Navy, and the Marine Corps, and our friends and allies. The program includes international partnerships with 8 countries – based on shared investment, full interoperability, and thus a concrete, shared stake in the future.
- Shipbuilding/ Joint Maritime Capabilities ($14.4 billion): The 2008 request supports the Navy's long-range shipbuilding plan, designed to produce a versatile 313-ship Navy by 2020. The increase of $3.2 billion over last year primarily supports the next-generation aircraft carrier, the CVN-21; and the LPD 17 amphibious transport ship. (The $14.4 billion includes Army funding for the Joint High Speed Vessel.)

The base budget is currently under relatively greater pressure than in past years, because the average age of equipment is rising. In FY 2006, the average age of nuclear attack submarines was about 18 years; of the Air Force's strategic airlift -15 years; of tactical fighters - 20 years; of tactical airlift - 26 years. It is important to address some of these issues now, since older equipment, as a rule, costs more to maintain and has lower operational availability.

One of the most critical recapitalization challenges is the Air Force's KC-135 tanker fleet, whose current average age is 45 years. The Air Force has announced a competition to replace this aircraft with the KC-X, which will be able to carry cargo and passengers, and comes equipped with defensive systems. This platform is the Air Force's number one acquisition priority, essential for total force global operations.

The end of the Cold War changed the calculus concerning the primary missile threat the United States faces – but in an increasingly proliferated world, the threat is more multi-faceted and less predictable than ever before. The United States is deeply concerned about missile developments in North Korea and Iran, and wary of China's recent use of ballistic missile technology to destroy space assets. Many other countries have or are seeking ballistic missiles.

The missile defense "good news story" is that with support from the Congress, the Department has already fielded an integrated missile defense capability that continues to get stronger and more effective. International missile defense cooperation with the United States continues to grow – in Europe, Asia and the Middle East. This budget request seeks $9.9 billion to continue that progress.[7]

In today's security environment, no single nation can successfully meet all the challenges alone. A critical part of the Department's strategic vision – highlighted in the 2006 Quadrennial Defense Review – is the importance of international partnerships. The Department is vigorously engaged in updating long-standing alliances, and reaching out to new partners around the world. NDAA 2007 provided a very helpful catalyst for this effort, in the Section 1206 authority for the Departments of Defense and State to train and equip partner nations' forces. The 2008 base budget request includes $500 million in dedicated funding for this critical initiative.

WHAT THE 2007 SUPPLEMENTAL BUYS

Before the Congress are two requests to fund war costs – the FY 2007 Emergency Supplemental Appropriation Request, and the FY 2008 Global War on Terror Request. They cover similar substantive ground – in three major categories: continuing the fight, increasing ground forces, and accelerating reconstitution.

The 2007 Emergency Supplemental request breaks down this way:

Continuing the Fight[8] $65.0 billion
Ground Forces[9] $10.9 billion
Reconstitution $13.9 billion

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[7] Includes $8.9B for the Missile Defense Agency; $0.6B for Patriot PAC-3; $0.4 for Patriot/MEADS CAP.
[8] Operations $39.3B; Force Protection and IED Defeat $10.4B; Military intelligence $2.7B; Security Forces $9.7B; Coalition Support and CERP $1.5B; Military Construction $1.1B; Regional War on Terror $0.3B.
[9] Accelerate Brigade Combat Teams and Regimental Combat Teams $3.6B; Grow the Force $1.7B; US Forces 'plus up' $5.6B.

Non-DoD Classified $3.6 billion

The Department's single greatest focus for our deployed men and women is force protection. Today, the single deadliest threat to our forces comes from Improvised Explosive Devices (IEDs). The terrorists who use them are highly creative and adaptive, they make use of relatively unsophisticated technologies to deadly effect, and they share "lessons learned" in real time. The Department is grateful for the support from Congress to date that has allowed the very rapid development and fielding of counter-measures. It remains critically important to continue this investment.

The most critical element of the Supplemental request is reconstitution – repairing and replacing equipment destroyed, damaged, or otherwise stressed from the demands of warfighting, to restore DoD inventories. When equipment is lost, the Department has a methodology for replacing it – with the latest appropriate model, not with something obsolete. The 2007 Supplemental includes these costs.

This 2007 Supplemental Request includes funds for the "plus up" of US forces deploying in support of Operation Iraqi Freedom. As the President has described, the additional forces are part of the nation's new way forward in Iraq. As the incoming Commander of Multi-National Forces-Iraq recently testified, their success will depend not only on their numbers, but also on their partnership with their Iraqi counterparts. The total cost of the "plus up" is projected to be $5.6 billion. Costs include supporting the deployment of 5 Brigade Combat Teams and an enhanced naval presence. This estimate may be increased by additional support troops, depending on Commanders' needs.

America's most direct partners in building stable and secure environments in Iraq and Afghanistan are the security forces – the military and the police – of those two countries. Ultimately, they and their political leaders bear the responsibility for establishing conditions for peace and prosperity, including standing up sufficient forces to assume security responsibility for their countries. The United States plays a supporting role – through training, equipping, mentoring and helping to sustain those forces.

Substantial progress has already been made. In Iraq, for example, well over 300,000 Iraqi security forces have been trained and equipped, and Iraqis have assumed full security responsibility for 3 of 18 provinces. Next steps include enhanced embedding of US forces to help increase Iraqis' ability to assume full control of security. In Afghanistan, one of the most important elements of the strategy to counter the Taliban and Al Qaeda is ensuring an indigenous Afghan capability to conduct independent counter-insurgency operations. The 2007 Supplemental Request seeks $3.8 billion for further support to the Iraqi Security Forces, and $5.9 billion for the Afghan Security Forces.

Successful counter-insurgency requires the application of all instruments of national power – there is no exclusively military solution. Economic development and security are two sides of the same coin – in the short term, you need security to get the economy going; while in the long term, you can't have security without economic development.

In the early days of Operation Iraqi Freedom, commanders on the ground recognized the importance of helping to jump-start the local economy. The Commanders' Emergency Response Program (CERP) provided limited but immediately-available funds, to make a concrete difference in people's daily lives. Many commanders considered CERP the most powerful tool in their arsenal. This FY 2007 Supplemental request includes $456 million to continue CERP.

One very important caveat: It is vitally important to the Department that the FY 2007 Supplemental be approved by Congress in a timely manner. By mid-April, if the request is not approved, the Department will need to begin reprogramming other funds – with all the associated disruptions to other efforts.

WHAT THE 2008 GWOT REQUEST BUYS

The FY 2008 Global War on Terror Request, for $141.7 billion, covers similar requirements, and will continue past the FY 2007 Supplemental.

The GWOT Request breaks into the following major categories:

Continuing the Fight[10] $96.6 billion
Ground Forces[11] $1.6 billion
Reconstitution $37.6 billion
Non-DoD Classified $5.9 billion

The GWOT request devotes $15.2 billion to continue force protection efforts – including technology to disrupt attacks, vehicles with V-shaped hulls to better to withstand blasts, and a new generation of body armor.

Successful counter-insurgency efforts in Iraq and Afghanistan, and more broadly in the war on terror, continue to require the closest possible partnership with host nations, and the application of the full spectrum of political, economic and security tools. The GWOT request includes $4.7 billion to continue the establishment of Iraqi and Afghan Security Forces, and nearly $1 billion for the CERP program.

CONCLUSION

The Department recognizes that the three requests before the Congress represent an enormous amount of the taxpayers' money. The Department also recognizes its fiduciary responsibility to spend those funds wisely. Detailed supporting data and rationale have been provided for each dollar requested, and staff from the Military Departments and from the Office of the Secretary of Defense are available for discussion and clarification.

Lastly, the Department is actively improving its processes to be more efficient and effective in all of its activities.

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[10] Operations $70.6B; Force Protection and IED Defeat $15.2B; Military intelligence $2.7B; Security Forces $4.7B; Coalition Support and CERP $2.7B; Military construction $0.7B.
[11] Accelerate Brigade Combat Teams and Regimental Combat Teams $1.6B.

Chairman Conrad, Senator Gregg - thank you for your support of our men and women in uniform. And thank you to each member of this Committee, for your support for all the brave men and women who wear the cloth of this nation. We look forward to your questions.

Chairman CONRAD. Thank you, Mr. Secretary.

Let me go right to it, if I could, and first discuss the difference between Administration estimates of the cost of the surge and what CBO testified before this committee. I referenced that in my opening remarks. I talked with you about this before the hearing, that this would be a question. And I think it naturally flows from what this committee has been told.

The original estimate that we were given from the Administration was that the surge would cost $5.6 billion. And the CBO said well, it would cost a multiple of that because of additional support personnel. Can you give us your best estimate at this time of what the surge will cost?

Mr. ENGLAND. If we can, perhaps between all three of us here we can bring some clarity to that. First, one of the differences, Mr. Chairman, is that we have costed the search through this fiscal year. So there is no money past 1 October in our estimate because, as Secretary Gates has testified, in his view we will know sometime this summer the success of that program, of the surge program. So we funded basically what we knew in terms of those requirements. So there is a significant difference there.

Also, my understanding is the Congressional Budget Office had a very, very large number of support troops. And we already have a large number of those support troops in-theater. So while the number we have estimated may vary somewhat, it is not at all going to be in that many orders of multiples that was estimated by CBO.

So I think there is just a difference in terms of the troops that are already there in the support arena versus added troops that would have to be provided.

Ed, you may add to that, and Tina.

Admiral GIAMBASTIANI. I think the question or the comment, first of all, on the length of what we had estimated out through the end of fiscal year 2007, so in other words through the 30th of September, there is a difference. I believe CBO was out to 2009 sometime.

In addition, the numbers of these combat service and service support or what we would call enablers also, there is a sizable difference. We have an established and well-established logistics base inside and outside of the area of Iraq. And therefore, we believe that we will need considerably less combat service and service support than was estimated there.

I think their numbers would be good if, in fact, we were doing this from a cold start.

Chairman CONRAD. Have we got the chart that has General Schoomaker, is it? General Schoomaker said, on February 16th in testimony, that the increase of 17,500 Army combat troops represents only the tip of the iceberg, and will potentially require thousands of additional support troops and trainers as well as equipment.

Do you disagree with General Schoomaker's assessment that this is the tip of the iceberg?

Admiral GIAMBASTIANI. I do not in that it will require some numbers of thousands of support troops. But with regard to the readiness issue, it is important for us to remember what he was saying. You have to get below the water level on the iceberg here to make sure we all understand on the readiness issue.

If we are training simply a force for counterinsurgency, then we lose some of the readiness that we might otherwise do for other types of conflicts. For example, if we have aircraft that are flying all the time and doing air-to-ground missions, they lose their air-to-air proficiency. So those are the types of things we are talking about.

But remember, this surge is 21,500 plus or minus some thousands here of support troops out of 2.4 million Americans in the active component and the Reserve component.

We have done a risk assessment and we understand that we are ready to meet any crisis or contingency that, frankly, we think will be posed to us. And the Chairman of the Joint Chiefs has signed out a risk assessment to the Secretary and the Congress. It is available to all of the defense committees in a classified form. All of us Joint Chiefs, myself included, have worked on that. I do not think this additional plus-up will change, frankly, that overall assessment that we will be ready to do our job to meet any crisis.

What will happen is there will be some added risk with regard to the time it takes us to be victorious or to win and potentially you will have some additional casualties. But let there be no mistake, we can get our job done if another crisis comes about.

Chairman CONRAD. Let me ask you this question because our obligation to our colleagues on this committee is to try to give them—we are not the policymakers with respect to how the war is conducted. That is not our job. Our job is to try to give our colleagues as accurate a reflection as possible of what things are really going to cost. That is the way I see our obligation. I know there are some, even on this committee, who want this to be the forum for debating the war posture and the war policy. I do not see that as that form.

I see our obligation as to try to give our colleagues as accurate an assessment is possible of the cost.

Can you tell me how many support troops have now been requested by commanders on the ground in Iraq to support the surge?

Admiral GIAMBASTIANI. What I would tell you is that right now we have approved requests for forces of about 2,400.

Chairman CONRAD. But that is not my question. I am asking how many have actually been asked for? I am told, from my own sources in the Pentagon, that more than 10,000 troops have been requested. Is that accurate?

Admiral GIAMBASTIANI. No, sir, it is not. What I was going to do is finish this off. There are 2,400 approximately that have been approved to date. And in addition, there are some additional requests for, I would gather, in the order of—for combat service and combat service support, detainee operations, these types of things—somewhere in the order of about 4,000 additional, 3,000, 4,000 that are there. But once again, these numbers are much lower than what you have seen before. And we are, inside the Joint Chiefs of Staff, reviewing these requests right now.

Chairman CONRAD. Can I say this to you, and I am going to stop here. My time is rapidly drawing to a close.

We are going to have to write a budget here in the next few weeks. We have not been given absolute assurance when our time will come, but it looks like probably the third week of March we will be on the floor with a budget. Which means this committee has to mark up the week before that.

Senator Gregg and I, through our staffs, are now talking about that kind of a schedule. It would be very helpful to this committee to have the most accurate assessment that we can get.

I find it a little troubling that the assessment, the numbers that have been given us before of $5.6 billion is for such a limited time, only until October 1st, as you describe it. It strikes me as just unlikely that this commitment would be that limited or that the costs would be that restricted.

Mr. ENGLAND. If I can comment, Mr. Conrad, I believe the Secretary's view on this is that we would know sooner rather than later the success of this effort in Iraq, and that we would certainly by this summer, his view and I believe General Petraeus' view, is by this summer we would have some pretty good measures in terms of where we are. As far as you probably know, the Secretary this afternoon is briefing on the measures and measures to the Congress. There is a briefing this afternoon on this whole subject. But by this summer we would have a much better indication in terms of the success of the program. And so at that time we would adjust however is appropriate to do so.

And I believe that is the whole concept here, is cost it through, get a level of confidence, see what happens and then we will adjust depending on what the outcome of this effort is.

The other comment I would make is I am pleased to hear of the schedule because the supplemental for us will be very important by like the middle of April. Last year it was very difficult for us because we had to start reprogramming. That caused great problems for as.

Chairman CONRAD. On that point, they are talking about doing the supplemental the last week of March on the floor. So that would be timely in terms of your deadline.

Mr. ENGLAND. Can I go back to the surge a minute, before you—

Chairman CONRAD. Yes, absolutely.

Mr. ENGLAND. Because I want to make sure it is clear. There is a war going on. And when the commanders on the ground, I mean things are going to happen and people are going to request troops. And the way that happens is it comes into the Chairman of the Joint Chiefs and they work this. So I would expect over a period of time there is going to be variations up or down.

That said, my judgment is that the budget we have should be adequate to handle whatever those variations will be. Obviously, the $5.6 billion is an estimate itself. All of the numbers are our best judgment. Some are slightly over, some slightly under. I mean, events change. But I do believe the budget. But if the changes, we will definitely get back with you quickly on this matter.

I would hope, however, that however these numbers may change, that we can accommodate them. If we cannot, we will definitely be back and talk to you.

Admiral GIAMBASTIANI. Mr. Chairman, if I could just emphasize the point the Deputy Secretary made about the fact that commanders come in all the time. We meet with the Secretary as a minimum once a week, the Chairman and our operations people, changing deployment and redeployment orders constantly with new requests in from the field, Afghanistan, Horn of Africa, Southern Command, all over the world, in addition to Iraq.

I would just tell you that we have new commanders in the field today. You have a new Multinational Corps Commander in Lieutenant General Odierno. You have a new General, Dave Petraeus, as you well know. You have confirmed him here recently. And he has only been on the ground since essentially the 10th of February.

So it will not surprise me if these commanders come up with different requests. So we are trying to give you the best information we have right now.

Chairman CONRAD. Put me down as a skeptic on the $5.6 billion. Senator GREGG.

Senator GREGG. Thank you, Mr. Chairman.

I think it is obvious the $5.6 billion is a number that is not accurate.

Independent of that, however, this supplemental request, and I understand your argument, Mr. Secretary, that these various items that I listed will basically be replacing items that are lost or are no longer functional or just go beyond useful life as a result of fighting a war on the ground in Iraq and Afghanistan. I think that can be debated, but it is a legitimate viewpoint. I give you credit for that.

But what I find difficult to accept, and this is rhetorically, you do not have to answer this unless you feel comfortable answering it, that a supplemental which is coming up to fund soldiers who are in the field at war appears to be coming—starting to be used by Members of Congress as a vehicle to load up with hometown interests.

We have the avocado growers in California throwing baggage on this train. We have the loggers in the Northwest throwing baggage on this train. We have the Gulf Coast states throwing baggage on this train. According to an AP report today, SCHIP is going to be included in this.

It is just incredibly unseemly, when we are at war, to be using a vehicle that is supposed to be supporting the troops who are fighting that war as a vehicle for basically taking care of issues which are probably legitimate, may be legitimate, but clearly are not part of the war effort and are part of the traditional piling on effort around here in spending money.

I suspect the Pentagon has no opinion on that, since you are just interested in making sure you get money for the war effort. But to me it is fiscally irresponsible and it is blatantly unseemly to be doing this, and inappropriate. We are supposed to be fighting this war, and paying for the troops, making sure they have what they need. We are not supposed to be paying for avocado growers in California and loggers in the Northwest.

Independent of that, on the issue of how money is being spent, it is hard to get a handle on just how much money has been lost there in the reconstruction effort. Nobody really seems to know. I am afraid when we write the history books on this, it is going to turn out to be a multiple billion number, maybe a very large multiple billion number.

But you have now set up these Commander Emergency Response Funds. Do you think these approaches, giving the commanders on the ground the flexibility to have the funds and spend the money, is probably producing a more efficient way of doing this reconstruction than what we started out with, which was to have an independent construction effort which was pretty much independent of the commander on the ground?

In other words, are we going to see less waste, fraud, abuse, lost money?

Mr. ENGLAND. So two comments. I meet regularly with Stu Bowen, who is the Special IG for Iraq. He was in my office just before he went back the other week, we met again. I think we go over his reports and talked in detail, et cetera.

Lately, there has been this discussion about $6 billion wasted. But yesterday, I mean literally I had one of the folks talk to Stu in Iraq about what is the basis of $6 billion. Frankly, there is no basis for this. I am not sure where—

Senator GREGG. You do not subscribe to the view that at the beginning of this effort there was flow into Iraq large sums of cash, multiple hundreds of millions, potentially billions, that is now not accounted for?

Mr. ENGLAND. I actually do not know. I do not know that.

I can only talk about reconstruction. And there were issues with reconstruction. There has been a lot of IG reports dealing with the reconstruction. And some of it was poor workmanship.

My indications, about 75 percent is just like you would find anywhere else in America. About 25 percent had various degrees of problems.

Senator GREGG. Well, if I can stop you there, there are specific instances involving health care reconstruction in Iraq that have been shown to be—it appears from reports—represented as non-existent but money was spent on them anyway. You are not aware of those issues? Or you see that as a State Department issue versus a Defense Department issue?

Mr. ENGLAND. Mr. Gregg, I guess some of it is Iraqi issues, because some of it was Iraqi money doing their thing. I am not sure I can differentiate.

Again, I can only tell you the IG's view, and having looked at the reports. I think certainly there is always some issues. It is a difficult environment.

Senator GREGG. Anyway, let us get to the essence of the question, which is the Commander's Emergency Response Funds a more effective way to manage the money coming into the country for reconstruction than what we were doing before?

Mr. ENGLAND. It is effective and, frankly, my judgment is and our judgment is it is crucial. The commanders do have good accountability of this money. They can put people to work. They can do things that are instantly beneficial to the people.

As you know, this whole effort is not just military, it is also economic. It is political in-country, and they have to work together. So this is part of the economic dimension that gives the commander flexibility that, along with the military effort, they can do things that are economically important to the people and do it immediately, real-time, which is what counts.

In the past, this has made a giant difference. Going forward it will be even a bigger difference. So this is very, very important money that was asked for.

Senator GREGG. It seems logical.

Mr. ENGLAND. It is logical and necessary.

Admiral GIAMBASTIANI. If I could, just to add to this, the CERP program, the Commander's Emergency Response Program, funding is—we consider it a different form of ammunition. It is the type of short-term projects that we can do. These are generally shorter term and smaller projects than the large reconstruction pieces.

Senator GREGG. You obviously did not run that phrase through a focus group, Admiral.

Admiral GIAMBASTIANI. I have not.

Senator GREGG. But I think it is an appropriate—

Admiral GIAMBASTIANI. It is a good way, I think, to talk about it. But we use it for such things as short-term, 60 to 90-day garbage cleanup, sewage disposal, those types of things, rehabilitating hospitals, fixing schools up, and those types of things. And we find that it gives the commander a way to talk to the local sheiks, to the local population. And that is why we think it is real ammunition for them.

So thank you for your strong support of this.

Senator GREGG. I think it makes sense and I think it is an adjustment which I wish we had made a few years earlier.

My time is about up, but I would be interested. Do you think it is unseemly that we are going to be using a war supplemental to basically fund domestic activities here in the United States which basically could be characterized as pork?

Mr. ENGLAND. As you said, Senator, we are anxious that we fund the United States military. And what the Congress decides to fund other than that is, frankly, up to the Congress. But I would hope that none of that detracts from the needs of our men and women in uniform.

Senator GREGG. Thank you.

Chairman CONRAD. That is a very good answer.

There is a differing perspective on this. This is a supplemental appropriations bill. The vast majority of it is directed toward the war effort. There are urgent emergency situations that have to be addressed by the Congress. That is a reality.

Senator GREGG. Even accepting that there may be issues that are emergencies, it is very clear that there is a lot being thrown on this train that does not even have a scent of emergency.

Chairman CONRAD. Let me just say that I, behind the scenes I have joined you in that sentiment. And I have told colleagues that I do not believe anything should be put on here that is not a true emergency. Those things that are costs that were fully predictable have no business being in an emergency supplemental. I have the wounds to show the fight behind the scenes on that.

And I can tell you we so far have stopped some things that I think would have been very egregious. Now I cannot, at this moment, tell you we have won all of the battles. I doubt it. But there been some things that were proposed that had nothing to do with emergency.

And we still have ongoing fights on things that I do not consider emergency and I know you would not.

But be that as it may, Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I do want to touch briefly on the President's new strategy in Iraq. The question that I would like to put forward to you is has there been an immediate impact of security, positive or negative, in Baghdad since either the President's plan went public or increased American forces have begun to arrive?

Mr. ENGLAND. Senator, I would say speaking or just looking at the reports from the people on the ground, I think their assessment would be it is too early to draw any conclusions because this is still in the early stages. So there have been reports about less sectarian killings et cetera. But I think the assessments I have read is it is too early to draw any conclusions.

So your conclusion is that it is early but anecdotal evidence early on indicates that there is a difference in a positive way that is happening? That would be another way of phrasing your response that would be acceptable?

Mr. ENGLAND. I would say that is valid. Admiral, you are even closer to the military. I will let you comment.

Senator ALLARD. Do you want to comment, Admiral?

Admiral GIAMBASTIANI. Yes, sir. What I would say is, first of all, I would confirm exactly what the Deputy said. We do not like a week or two, if you will, just a week or two of statistics to indicate an overall trend because we have learned over long years of doing this—

Senator ALLARD. I can understand that.

Admiral GIAMBASTIANI. However, we do see sectarian killings are down right now and that is substantial. We hope that that trend continues. But it is not really a trend yet. So these are the early anecdotal pieces, the statistics we are looking at.

I talked to General Petraeus yesterday on this very issue, and he relayed that the sectarian killings are down.

One other potential bright spot—potential, I might mention—is that the sectarian migration from Baghdad, for example, and throughout the country is also down.

Senator ALLARD. That is encouraging.

Admiral GIAMBASTIANI. So those two things are a little bit of a bright light.

Senator ALLARD. Which means they are more comfortable at home.

Admiral GIAMBASTIANI. Yes, sir, but too early to tell.

Senator ALLARD. Yes, I understand.

Another aspect of the renewed initiative is more flexibility for our troops when they are combating outside forces that provide advanced weaponry and training to our enemies in Iraq. What about those impacts?

Admiral GIAMBASTIANI. I did not quite understand your question.

Senator ALLARD. As I understand it, part of the President's new plan includes flexibility on outside sources of weapons coming in. Those soldiers have more flexibility in addressing those individuals when they come in contact with them. Has this had an immediate—has this had, again anecdotally at least, has it provided any positive or negative impact as far as advanced weaponry or training?

Admiral GIAMBASTIANI. What I would tell you is as far as what is coming in from outside, I think it is public that we have actually had some raids recently where we have picked up materials. But I do not think we can tell you what the overall effect is on the level of violence.

I will tell you though, separate from what may be moving across the borders, we have, in fact, found a couple of the significant caches of improvised explosive device material here over the last 2 weeks. Once again, General Petraeus was mentioning these to me. We are very pleased that these were bomb factories that were in and around the Baghdad area, and finding large caches of these types of things, particularly the more advanced ones, is very important to stopping violence and obviously causing casualties to not only coalition forces, United States forces, but also to the civilians there.

Senator ALLARD. DOD's Selective Acquisition Report, commonly referred to as SAR, is one of the tools—some say the best tool—for understanding the future budget consequences of present and past decisions. Now SAR measures the total acquisition of costs of major weapons systems.

In September of 2001, they come up with an aggregate cost. And then 4 years later in 2005 they come up with another aggregate cost. I have those coming up. And the cost doubled in the 4-year period there.

Are we going to have some serious affordability problems when these developmental system such as future combat system, the Joint Strike Fighter and the DD–21 hit full production a few years from now?

Mr. ENGLAND. Senator, I would tell you we have issues today. Frankly, most of our equipment we buy at very, very low rates. And we buy them at low rates because that is the rates we can afford. But when you buy them at low rates, they cost you more.

We are in this cycle frankly, of—

Senator ALLARD. They cost you more because you extend out the program? Is that what you're saying?

Mr. ENGLAND. Yes. And obviously a car a year, if you built it, is not like if you built a million cars a year. So whenever the rate is low, the cost per unit is higher for us.

So we are generally, across all of our equipment, we are at very low rates. And when we need to adjust, what we do is we stretch the program. So cost goes up but that year the cost goes down.

Although we have managed to increase—since President Bush, we have gone from, I believe, $40 billion to $100 billion a year in procurement. This year it is $101 billion. But you know, for a long time, in the 1990's, we did not buy much equipment. So a lot of that equipment hasten very old. So if you look at a lot of our assets now, particularly Air Force assets but also even some of our submarine fleet is 18 years old now. A lot of those assets are aging.

Right now, for example, this year we have put out the tanker program RFPs, but our tankers are already well over 30 years old. And by the time we replace them, I mean some of them will be 50 or 60 years old.

So yes, it will be an issue in the future and it is an issue today, frankly. We keep trying to increase rates but costs go up about as fast as our budget.

Senator ALLARD. And particularly the equipment that we have in the dry, sandy environment in Afghanistan and Iraq. That equipment wears out much quicker because of the hostile environment with the sand and everything it has to operate in. And when you put this off, it tends to snowball at the end. And that is some of the concern that I am trying to express here.

Mr. ENGLAND. And I appreciate it, Senator, because it is very important. In our budget and in these supplementals, of course, we have reconstitution money to replace that equipment. That was part of the discussion we had even on the airplanes. It is hugely important that we have the funds to repair and replace all of this war equipment. Otherwise, when this is over, we would leave literally a hollow military. So it is an obligation, I believe, both of the people in the DOD and the Congress and the American people, to make sure at the end of this war we did not have a hollow force.

So each year we put money in the budget to repair and replace the equipment that is being worn out, damaged or destroyed as we pursue this global war on terror.

Senator ALLARD. Ms. Jonas, do you have any comments in that regard? I noticed you were kind of nodding your head there.

Ms. JONAS. Well of course, as the Deputy said, on the reset piece we have about $13.9 billion in the supplemental for resetting and reconstituting. And in the GWOT request that we have in for 2008 we have another $37 billion. So that is very important to the Department.

Senator ALLARD. Mr. Chairman, I see my time is expired. Do you want me to continue? No, go ahead.

[Laughter.]

Chairman CONRAD. If I could go to a separate question, we are considering, we have not yet reached conclusion, but I would like to have your thoughts on this. And I know that you are here as representatives of the Administration and so you have to support the Administration's budget request just as it is through the 5-years. I am not asking you to contradict any of that.

We are considering using a CBO score on war cost.

Let me back up and say, first of all, we are thinking of putting in as a defense request the money the President has requested of the basic defense request. Then in terms of the war cost request, we are considering using a Congressional Budget Office estimate that over the 5-years is actually $85 billion roughly over and above what the President has requested because, as you know, the President has no request past 2009.

But as part of that, the CBO estimate for the next year is slightly under, I think about $20 billion less than the President. The next year it is $25 billion more. The next year it is somewhere in that range, $25 billion more. So overall through the 5-years, it is actually $85 billion above what the President has requested.

Senator ALLARD. Mr. Chairman, so the first year here in 2008, there is actually a reduction of $20 billion? And then you pick that difference up?

Chairman CONRAD. The next year you have $25 billion more. The next year you have some $25 billion more. And the next year—

Senator ALLARD. But isn't the first year of the budget the most crucial aspect of the 5-year budget? I mean, that is the one that really speaks to what actual spending is going to be. And then the out years after that, that is just a matter of moving the figures around.

Chairman CONRAD. Well, you know, it is a 5-year budget. So every year the President has estimates of what the costs are. We have estimates. Over the time—and we will be scored for the whole expenditure. We will be scored as spending $85 billion more than the President. When they draw the lines, they will say we are $25 billion more.

We are in a situation where you have to have some basis for making these estimates. You get an estimate from the Department and the Administration. You get an estimate from CBO. We are trying to use some objective third party so that there is some merit to the number.

Would you have any comment on that?

Mr. ENGLAND. Mr. Chairman, first, I have not seen the CBO estimate. But again, even for fiscal year 2008, we literally took an extension of 2007 because we did not know if 2008 is up or down. And if you do not know if it is up or down the safest thing to do is to just straight-line it. So that is what we did for 2008.

Chairman CONRAD. I understand how you arrived at it. That is why CBO has looked at your analysis and they have come up with a marginally different conclusion.

Mr. ENGLAND. But when they look out to 2009 and all that, I do not have any idea how they would project that because we do not know how to project it even a year ahead because it is a war and you do not know—

Chairman CONRAD. But Mr. Secretary, to estimate that it is nothing, I mean that is what the President's budget is telling us, there is no cost. We are talking now about Iraq and Afghanistan. Saying there is no cost just strains credulity, frankly.

Mr. ENGLAND. I would expect certainly there is going to be some tail cost to all of this. When the war is over, we know there is a reconstitution cost, for example, which we have testified that even when the war is over there is equipment at the end that will have to be refurbished. So I am not sure what that rationale is.

I am not sure how you estimate it. It is not zero but I do not know what that number is, Senator.

Chairman CONRAD. I appreciate that. We do not know either. We are searching here for something that is credible and defensible and we have not reached conclusion on these matters. But we are trying to find some objective measure that has—at least appears to have some credibility attached to it.

Senator GREGG. Can I pick up on that point?

Chairman CONRAD. Sure.

Senator GREGG. If you assume that you are going to the answer to whether the surge worked or not by the middle of the summer, which was your statement, or a pretty good feel for what is going on, is it reasonable to assume that next year's supplemental war costs can be reduced by the amount of the surge costs because that number would be no longer needed?

Mr. ENGLAND. I would say, Mr. Gregg, by this summer, depending on what the situation is and what the projection is, at the time we would certainly update the estimates going forward for 2008. At this point, I do not know if that is up or down. But we would certainly know more. I think that is the general consensus, that by the middle of the summer we will know more.

Senator GREGG. What the chairman is saying is that they are reducing your straight-line projection by $20 billion for the year 2008. I do not know where they are taking that money and what they are doing with it.

But my question would be of that $20 billion, if the surge cost is $5.6 billion, that is your estimate—even though I not it is rather low—is it reasonable to assume that at least that amount could be reduced from the straight-line projection?

Mr. ENGLAND. Again, if the surge continues past 1 October, then there would be costs added for the surge because there is no surge cost past 1 October. So again, it would depend on what the circumstances are this summer. So it could go up or down.

Senator GREGG. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator NELSON.

Senator NELSON. Thank you, Mr. Chairman.

First of all, you have my commitment to support you and Senator Gregg as you all are trying to get your arms around this overall spending. If I may, since we have such esteemed leaders of our Defense establishment here, I would like to get into a couple of specific programs with your permission, Mr. Chairman.

Chairman CONRAD. Absolutely.

Senator NELSON. I feel compelled, on the basis of the commitment I made to the Marines in Western Iraq, to bring back and articulate on behalf of them their need to shift from a flat-bottomed vehicle to the V-bottom vehicle, what is called the MRAP vehicle.

Do you all have any direct knowledge that we are going to increase the production of these vehicles so that the Marines will be able to have them instead of the flat-bottomed vehicle?

And the Army seems to have a lack of interest in this V-bottom vehicle. Why?

Mr. ENGLAND. I do not think they have a lack of interest, probably not the same need. Now we have some V-bottom vehicles in Iraq today. We do have Buffalos, we have different vehicles.

The Army is typically in heavier vehicles than the Marine Corps. So with their Strykers and their tanks and everything else they have, I believe they have more protection today than the Marines.

So going forward, they do not have the same number. But they do have needs and they have articulated quantities of these vehicles, also. I do not have the exact number. They also have a need, but it is not as high as the Marine Corps just because the Marine Corps, it is a lighter vehicle in the past. So they have more of a need for this vehicle going forward, Senator.

Senator NELSON. Does the Army have everything other than the up-armored Humvee?

Admiral GIAMBASTIANI. Again, what the Deputy said is very important. If you take an Armored Cavalry Regiment, for example, if you take an armored unit there are very heavy on Bradley fighting vehicles, they are very heavy on M1 tanks. Our best armored vehicle out there is an M1 tank.

We also have now a series of three going to a larger number of Stryker Brigade Combat teams. These are very effective, much more effective than up-armored Humvee vehicles. The problem with the Marine Corps is they only have one tank battalion for the entire Marine Corps. So they normally move in either one, Humvees; or two, they will move in amphibious assault vehicles. So their need for these types of, if you will, armored vehicles is greater than the Army's is.

The Army actually started the work on these and brought them in in their route clearance teams and populated their explosive ordnance disposal combat engineers. So there is a tremendous interest on both the Army and the Marine Corps part. The difference is that the Marines want to replace essentially most of their Humvees, which the Army does not transport by to the degree the Marine Corps does, percentage wise.

Senator NELSON. Right, but the Army does transport with up-armored Humvees?

Admiral GIAMBASTIANI. Yes, sir, they do.

Senator NELSON. So why wouldn't they want to move like the Marines do?

Admiral GIAMBASTIANI. They do want to and, in fact, we have a sizable request, as a matter of fact, in for these V-shaped hulls for both Army and Marine Corps in the current budget submission and supplementals. You will see those in there now.

Senator NELSON. On another subject, you all have been reading the daily chronicles of the Washington Post with this stuff that is going on out at Walter Reed. This is not the first time that I have heard of this, because I have heard of the lack of attention of medical care to our troops.

It was extraordinary the other day when the winner of the Congressional Medal of Honor, Senator Danny Inouye, told what it was like after World War II or during World War II, in his case when he lost his arm, that the military would not release them from active duty military until they had had all of the rehabilitation and all of the counseling and so forth so that they could cope with their wounds.

And that seems to be the opposite of what we are doing. We are releasing them and letting them fend for themselves, not even to speak of what the Washington Post is talking about in the deficiencies out at Walter Reed.

Your comments, Mr. Secretary?

Mr. ENGLAND. Senator, I guess it is sort of multifaceted here. First, there is an independent review group that the Secretary of Defense has put together to look at all aspects of this. And so that group is being stood up so we get an independent look at it.

Personally, I go out to Walter Reed regularly, and I think probably a lot of people in this room do. I meet a lot of the wounded people at ball games we take them to, and soccer games, and dinners almost every Friday night. Frankly, the people I meet, we ask every single person how are you doing? How about the parents? How is your spouse? How are the kids? And if we hear about a problem, we fix it for them.

Look, I do not believe this is widespread. The people that I talk to specifically, and they are pretty straightforward because they come to tell me—I ask them. And I can fix things for them, so they are pretty forthright about it.

I believe we give the best treatment in the world to our men and women in uniform. But frankly, it sounds like some have fallen through the cracks. We will know more with this independent review team.

I can tell you, it is the full intent and the dedication of every single person in the Department of Defense to provide them the very best care we can. I know that goes for the VA also. And we work extraordinarily hard to do that.

The Secretary of Defense has also said that he holds people accountable because we do have a standard of care for people who serve in our military. So he has a standard of accountability. And I can tell you, this is very serious for us because it underlines, I mean the people we serve knowing that we care for them is fundamental to everything.

Senator NELSON . Do we muster them out and then turn them over to the VA, unlike what Senator Inouye said in World War II, that they would not release them until they had rehabilitated them?

Mr. ENGLAND. I think a lot of people—just about everybody there are still active military. Occasionally, I will have someone that will come to me asking for a special—can we look into maybe keeping them a few more months for some reason. But a lot of these folks are with us for a couple of years after their injuries.

Of course, a lot of them we keep back in the military. They come back and serve because we have roles in the military they can continue to serve. Some of these great Americans—I was just with someone last Friday night back in jump school who lost his leg back in jump school. We have a number of people like that who lost limbs and are still serving.

So my view is the vast, vast majority of people we treat extraordinarily well because we work at it very hard. But it is pretty obvious that it has not worked 100 percent of the time. We are going to understand why. We have a review group to look into that. And we will do whatever and anything it takes to make this absolutely perfect.

Senator ALLARD. Senator Nelson, may I followup on your line of questioning if it's OK with the Chairman?

Chairman CONRAD. It is really on Senator Menendez.

Senator ALLARD. I do not plan on taking much time.

Are we expanding Bethesda Medical Complex out there to begin to take the soldiers and everything that were going to Walter Reed?

Mr. ENGLAND. Yes, Senator. As part of BRAC we decided rather than having two separate medical facilities in the Washington, D.C. area, we would have one literally world class facility and that would be Bethesda-Walter Reed.

Senator ALLARD. Because I saw that a lot of infrastructure at Walter Reed looked like they were in pretty bad shape. But we are building a new facility then?

Mr. ENGLAND. Yes, we are. We will have a whole new facility at—we will have the current facility plus other facilities expanded, our medical school. It is right there. The National Institutes of Health is right nearby. So the whole plan was to have a complex new, modern, with our very best capability at one place, rather than dividing it between the two locations.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, I want to go—I understood there was some discussion here before. But I want to return to the costs of the escalation of the war, where the Administration has asked for $5.6 billion.

If the Chairman were to put you under oath, would you say that that is the total cost of the escalation?

Mr. ENGLAND. Yes, I would. I would have one proviso. I would say that it is a war we are in. So things are going to change on the ground.

Earlier, we said the commanders have asked for some additional support personnel and things, and that is being evaluated by the Chairman's office today. So there will constantly be some variation in this. But that is very close. That was the best estimate at the time.

Senator MENENDEZ. How is it that the CBO comes here before the committee and says that they have a really different sense of what you need in support troops, based upon your own standards? And we are being told, I understand your earlier testimony here is that you only need a couple of thousand. What is the total amount of support troops that you are going to need for the escalation?

Mr. ENGLAND. The Admiral testified just earlier that if you were doing this from scratch, you would need more support troops. But we are not doing it from scratch. We have a lot of support troops already in-country, deployed in-country. So there is a benefit, in a sense, of having already deployed forces—

Senator MENENDEZ. My question is how many will you need in addition to, for purposes of this escalation? What is the total number?

Mr. ENGLAND. It is going to be in the several thousands category, so we have some estimated. The Secretary said 10 to 15 percent added to the 21,000.

There has also been requests now—

Senator MENENDEZ. So are you talking about 3,000? Are you talking about 5,000? What are we talking about?

How do you ask us to budget in the blind? How do you ask us to provide moneys you in the blind? You must have some sense of what the support troops that you will need to backup your escalation.

Mr. ENGLAND. So the answer, Senator, is 10 to 15 percent is what the Secretary of Defense has estimated of the 21,000, so that is somewhere around 3,000.

Senator MENENDEZ. That is the total amount of support troops you think you are going to need for this escalation?

Mr. ENGLAND. And in addition, General Petraeus on the ground has identified some additional needs, in terms of people. That, I believe, is on the order of 3,000 to 4,000. And that is currently being evaluated by the Chairman's office.

Senator MENENDEZ. So if that were to be accepted, then we are talking about anywhere between 6,000 and 7,000?

Mr. ENGLAND. That is correct.

Senator MENENDEZ. In your request to the Congress for the $5.6 billion, do you include the 6,000 to 7,000 additional support personnel?

Mr. ENGLAND. In terms of the funding, our judgment is that that will fit within the funding we have requested. Our funding is not just $5.6 billion. It is our defense budget to conduct the war. So we conduct the work. We do not tag people to fit $5.6 billion. We conduct the war. That is a delta cost of the war.

So within the total costs—I mean, obviously some things change. Some things are plus, some things are minus. Within this cost estimate, our best judgment is we can handle whatever those costs are for whatever the support costs are—

Senator MENENDEZ. You mean within your overall request, beyond the escalation?

Mr. ENGLAND. Again, because this is a war cost—I mean, we do not differentiate the dollars.

Senator MENENDEZ. I know, Mr. Secretary, it is a war cost. But the reality is you do not have a blank check from us. I hope you do not expect a blank check from us. It is tough enough to look at the budget and try to figure out what you want to moneys for. I know money is fungible, but at some point you just cannot have an endless pot without justification.

Mr. ENGLAND. We provide you, Senator, 35,000 pages of backup for our request.

Senator MENENDEZ. That is why the CBO said that they had to go through extraordinary efforts just to determine what, in fact, you were asking for, what purposes.

Let me just say, I do not believe, for the life of me, that $5.6 billion is going to be enough. Are you going to come back for a supplemental?

Mr. ENGLAND. A supplemental?

Senator MENENDEZ. Yes. Are you going to come back for a supplemental in 2008? In addition to your overall request, not only for the escalation but all your other requests. You are going to come back for a supplemental?

Mr. ENGLAND. In 2008 there is a GWOT request in now, in addition to the base budget. So there is $141 billion, as I recall, which is the GWOT costs, our best estimate of what the 2008 cost of the war will be based on our 2007 expenditures.

So there is already submitted to the Congress a $141 billion request for fiscal year 2008 that is not part of the base budget—this is a discussion we had earlier—which is a supplemental.

Senator MENENDEZ. Mr. Chairman, I do not know if you are having a second round or if I can pursue this. I see my time is—I am sorry—

Mr. Chairman, I do not know if we are having a second round or if I can just pursue a little longer?

Chairman CONRAD. No, you can go. We have allowed others to go further.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, let me just get one more thing on this. So now you have support troops in the field, but they are supporting present missions. Are you saying that your standards—maybe the Admiral can respond to this—that the same standards that the Department of Defense has about the X number of personnel to support active combat personnel is going to be diminished? That you are going to have less than your normal standards?

Admiral GIAMBASTIANI. If I could help to answer that for you, Senator, first of all with regard to the support personnel necessary. One of the comments I had made earlier, before your entry, was that we are operating on an established series of logistics bases, and in particular, around the Baghdad area where the plus-up is going. So we already have a substantial logistics combat service and service support establishment there.

So when we bring in additional troops we can accommodate some level of them with the already existing support troops, which is why when CBO would estimate—I did not look at their estimate. But I believe they did it using the standard metrics for an unestablished or a new base of operations, where you would need a substantial number of support troops. Which is why our estimates are lower.

The second thing is that they estimated through fiscal year 2009. We have only estimated the cost through the end of this fiscal year, which I know you know. That is that $5.6 billion.

Senator MENENDEZ. So then if one is to believe that the escalation continues beyond, your cost will be greater, obviously.

Admiral GIAMBASTIANI. I think one would have to say yes.

Senator MENENDEZ. Let me just turn to one other question and then I will stop.

Mr. Secretary, I met with the Special Inspector General for Iraq Reconstruction. The Administration comes before the Congress and asks for all this money. I have a real problem when the Special Inspector has told Congress that 15 percent of all of the money that the United States has spent on Iraq Reconstruction has been wasted, and that they are investigating cases of potential criminal activity.

I have a real concern when we spend $43 million for a residential camp for police training personnel that is never used, when we spend $4 million on 20 VIP trailers and an Olympic-sized pool not authorized by us. I have a real problem when the Inspector General found that the government may have spent $36 million on weapons and equipment that they cannot account for. I have a real problem when we take $4 billion into Baghdad on giant pallets aboard military planes and cannot account for a good amount of it.

How do you expect us to continue to give you an open check with such incredible waste, fraud and abuse?

Mr. ENGLAND. Senator, I also meet with Stu Bowen regularly.

Senator MENENDEZ. Do you hear the same things that I hear from him?

Mr. ENGLAND. No, I do not.

Senator MENENDEZ. You do not?

Mr. ENGLAND. I read all the reports. I have read all of the reports, Senator. I have actually read all the—seen all of the pictures, talk to him regularly.

I do not think he said it was 15 percent. I think he said he did not know what it was. But without doing an analysis, if he just had to guess, he would guess it would be 10 to 15 percent. But he actually did not know.

But there is obviously some level, I mean it is a war. So there are some things that obviously do not work out. I mean, some of the buildings—

Senator MENENDEZ. Mr. Secretary, I hate to interrupt you, but is that an excuse for everything?

Mr. ENGLAND. It is not an excuse at all.

Senator MENENDEZ. I understand war has its exigencies and unexpected circumstances. But that is also not an excuse. Every time we ask the Administration, the answer is we are in a wary. But even some things are clearly definable. There are control mechanisms to be had to make sure that we do not have waste, fraud and abuse.

Saying that we are simply in a war is not acceptable.

Mr. ENGLAND. He is part of the control mechanism, so that is part of what the IG does is uncover issues so we can go fix them. We work at those. And so whenever we find a problem, we do work those problems. It is not an excuse. It is a just a fact of the environment where they are.

Where there is waste or fraud, we obviously work that. There are people who do egregious things, just like they do in the civilian world. There are people who take advantage of circumstances. And fortunately a number of them have been caught and convicted, and I applaud that. That is exactly what should happen.

So we do not have perfect people, like no other organization does. But we do have systems in place like the IG. That is the purpose is to uncover those problems so they can be fixed. So we work closely with the IG.

Senator MENENDEZ. My final comment, and then I will cease. It is not whether we have perfect people, Mr. Secretary. We know we do not have perfect people in the world. It is not whether—the IG should not be the vehicle by which we—that is the after fact.

It is the Department of Defense that needs to have control mechanisms to ensure that the taxpayers' money that we give to you is ultimately spent in the most efficient way, both for our people who serve us in protecting them and meeting their mission, and also in terms of these other elements that the administration has asked for.

To say that the Inspector General is part of that control mechanism, that is the after fact. He finds out what went wrong. The question is what mechanisms does the Department have. And I think the Department does not seem to feel that they need to have mechanisms.

Mr. ENGLAND. Last year we conducted 35,000 audits, Senator. So we have a lot of controls in place. But again, not everything is perfect and we appreciate the efforts of the IG.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator. I feel the need to set the record straight on a couple of things.

In terms of the CBO estimates, the CBO estimates were based on experience in Iraq, not just in other places but in Iraq, and specifically on the surge in 2005. And when we look at total troops, ground forces in-theater, and the number of combat brigades and the number of troops per combat brigade, the lowest number of troops per combat brigade was back on December 31st of 2004. That was the lowest since 2003, and it was 8,300.

That would equate to a total of over 40,000 troops for the surge. This is the basis for CBO's estimate. It is based on previous experience in Iraq.

Let me go to the Washington Post story and Walter Reed, because I watched the Secretary. I thought his response was exactly right. I thought he was personally angered and offended by what was occurring there. And he is right to be.

I think we have to differentiate. What is happening in combat is the best medical care in the history of warfare. That is the record. It is remarkable what an exceptional job the American military is doing of providing medical care in combat. So that needs to be laid out there and stated, because it is a fact.

Second, when they come home and they are going through medical treatment directly at Walter Reed and Bethesda, that is excellent care. Many Members of Congress get their care from those same caregivers. And I think all of us would acknowledge their excellence and their incredible dedication.

We also know as a fact that there are serious problems with those who are outpatients especially, and those who have need for specialty care and delays in getting appointments.

The Washington Post story, let me just refer to it. You have all read it. Ever member of this panel has read it. They talk about how the wounded can wait for weeks with no help from staff to arrange treatment.

Now these are typically people who are either outpatient or who are in these auxiliary facilities.

Recuperating soldiers are asked to manage and guard other soldiers. Caseworkers are untrained and there are not enough of them. Lost paperwork and bureaucratic delays are common.

Look, I have had a fair number of soldiers wounded from my home State. We have found a lot of bureaucratic delays, a lot of things that should not happen. And that has to be addressed.

Can you tell us, Mr. Secretary, what is being done to address that?

Mr. ENGLAND. Senator, first of all, there are a lot of things being done immediately on-scene. But I believe the most important thing is this independent review team that the Secretary has put together to report back to him, to look broadly at this whole issue, to make sure that we are doing it right. We actually want people from the outside, but with some familiarity, to come in and critique the system. So we have asked people to do that. I believe that is the most valuable thing, so that we can fix whatever the systemic problems are.

Frankly, it is not difficult to go fix a room or whatever that is not right. All those things are being done. I think more attention immediately is being taken at Walter Reed.

But the question is do we have a systemic issue? And so this independent review team will examine that.

I will tell you the Secretary, as you rightly observed, is pretty much outraged, as we all are. So we take this extraordinarily serious. I mean, these soldiers are part of the family. These are people who we dearly love who serve in our military. They are family members for us and many of us know them as family members. So we are going to take whatever action we need to do. And that is anything we need to do. This is the most important job we have.

So whatever those issues are, they will be addressed systemically and fixed.

Chairman CONRAD. This is a story from this morning “Hospital Officials Knew of Neglect: Complaints About Walter Reed Were Voiced For Years.”

This is one of the most disturbing stories that I have read actually, out of this whole sad episode. I would hope that people who knew that there were very serious problems and did not act or did not sound a warning, that those people be held accountable.

Mr. ENGLAND. They absolutely will. The Secretary said that. This is a failure of leadership. And appropriate people will be held accountable. So that will definitely happen, Senator.

Chairman CONRAD. I appreciate that. It is important that it be done.

Senator LAUTENBERG.

Senator GREGG. Mr. Chairman, can I just ask, just as a technical point, the Chairman has now had 2 second rounds and I have not had a second round yet. And we have gone back to your side three times, prior to coming back to our side.

Chairman CONRAD. We would be happy to go to the Senator.

Senator GREGG. I know it is the minority being difficult again.

Chairman CONRAD. No, no.

Senator GREGG.

Senator GREGG. I am sorry.

Chairman CONRAD. I was trying to give people who have not had any rounds a round.

Senator GREGG. You are correct, and I appreciate that.

Senator LAUTENBERG. I want to defer.

Senator GREGG. No, I just wanted to make my point and then I will defer to the good Senator from New Jersey because he has not been here, and let him make his points.

Chairman CONRAD. You know, the way it works, and I know it worked this way when the ranking member was Chairman, when additional members come that have not had a round, we give them their round.

Senator LAUTENBERG.

Senator GREGG. I agree. We should have stopped your round. He was complaining as soon as he came.

[Laughter.]

Chairman CONRAD. Senator Lautenberg.

Senator LAUTENBERG. If it is urgent—

Senator GREGG. No, please proceed.

Senator LAUTENBERG. I think mine are, not to make light of the subject here today at all.

There is so much heavy weight over the country and over the citizens in the country and we see it not just in the polls, but if you get out in the field and you talk to people. I do not care where you meet them or what their profession or what their economic standing is, they are worried about this war. They really are.

The last couple of nights we have seen the Woodruff experience—I do not know what the title of it is. But it demonstrates, more than one can imagine, the pain of war.

I served in World War II during the active war in Europe and I take pride in my service as a veteran. It was not heroic but it was steady, in terms of my work.

And so when I look, Admiral Giambastiani—[continuing in Italian.]

I wanted to ask about recruiting. What is the situation? What has it been like for the last couple of years, Admiral?

Admiral GIAMBASTIANI. With regard to recruiting across all of the services, frankly about 3 years ago we wound up having a problem inside the United States Army. This is just as we were increasing the overall levels within the Army, increasing through the supplemental by 30,000. So we had an in-strength for the Army of 482,400. We increased that, Congress allowed us to go up to an additional 30,000 at the request of the Administration.

During that time, over 3 years ago, when we first started moving up, we had difficulty meeting our new goals in the Army. However, I can tell you that for about the last year and a half all services have continued to meet their goals.

This month, for example, and the Army has continuously met their goals—I will take a look at it in just a second but I think it is about 15 or 16 months in a row. They were over 100 percent. The Navy is over 100 percent on the active component. The Air Force is over 100 percent and the Marine Corps is. So all of the services are meeting their goals.

Now that does not mean it is not a tough recruiting environment, but we project that we will meet our goals throughout the rest of this fiscal year also, even though we have additional in-strength and additional recruiting coming on. We have authorized the Department, and the Secretary has authorized and requested an additional 5,000 Marines and an additional 7,000 soldiers for the Army per year.

Senator LAUTENBERG. Is the same true of the Reserve Corps?

Admiral GIAMBASTIANI. Now, on the Reserve component side, we had some difficulty also meeting our National Guard in-strengths however, and I am going to pull out my figures here while we are talking, we did make Army National Guard goals. Let me just get these numbers here and I will tell you exactly.

Army National Guard recruiting was 113 percent. Army Reserve, however, was just under, at 94 percent. United States Navy Reserve, but by request of the CNO, was a little under 90 percent. And then the other services made the Reserve components.

Senator LAUTENBERG. Thanks very much, Admiral. What did we have to do to meet those goals? Did we change our standards?

Admiral GIAMBASTIANI. I would tell you no, sir, we did not fundamentally change our standards. What we did is the first thing we did is put many more recruiters in the field, particularly in the Army and the Marine Corps. The Army had to put a lot more.

Have we changed and allowed some additional folks to come in? The answer is yes, but not in large numbers. Not in large numbers.

Senator LAUTENBERG. The time is short, so unfortunately I have to leave that subject. I am concerned about that.

Madam Secretary, is there any thought to increasing pay for hazardous or combat duty for our troops serving in Iraq and Afghanistan? I particularly look to those who are called up from the Reserve units, be it the Guard or the regular Reserves, where families left behind do not have the advantage of a base facility for medical or health care, and their tours of duty are much longer than ever, ever anticipated.

So is there any thought to making life a little bit easier for those who are serving in the combat theater, to pay extra bonuses for their service?

Ms. JONAS. Mr. Lautenberg, we appreciate the question.

The budget that we have before the Congress right now includes a substantial amount on both topics for recruiting and retention, about $4.3 billion. There is a specific consideration for providing—I believe it is $1,000—for Reservists who are extended beyond the time that they are supposed to serve. So that is a piece of it.

We are constantly working with the personnel and readiness community to make sure that we have appropriate bonuses and support for the families.

Senator LAUTENBERG. Mr. Chairman, can I have another—

Chairman CONRAD. Yes, sir.

Senator LAUTENBERG. I really appreciate it.

The question that comes to my mind as we look to escalate and expand the number of people there, it is a shocking thing to look at. I was the first legislator to go to the Gulf War I theater and we had 540,000 troops there. And now to be doing the job that our people are being asked to do—and they are doing it heroically and bravely and often at a disadvantage because of equipment delays.

I just wonder, if we do succeed despite greatly opposing opinion here and in the world outside of here, do we guarantee that the people that we are going to send there will have the latest in the equipment, everything that they need? Will the vehicles be armored sufficiently? Will the flak vests or body armor be the latest that is available? Will it be there at the moment of their arrival?

Admiral GIAMBASTIANI. Senator, I can assure you that anyone we send into combat to do any of this work will have the appropriate equipment, both body armor, armored vehicles, ammunition, food supplies, whatever it is.

Senator LAUTENBERG. That has not been our experience, Admiral, in all due respect.

Admiral GIAMBASTIANI. No, sir. I just want to come back to you for a second here. We will never have enough of everything as we change something new. Let me give you an example.

We have changed our body armor many times. But anybody who goes outside of what we call the wire, moves outside of our bases, and goes on operations, we give the front-line armor to, the front-line armored vehicles.

Now inside forward operating bases, for example, in Afghanistan and Iraq, we have unarmored vehicles, we have slightly armored vehicles, and they will operate on those. I have just been to Baghdad a couple of weeks ago. I was driving around in a Suburban. I did not wear my armor most of the time, and neither did any of the troops with me. But as soon as we went outside of the base, when we were flying in helicopters and the rest—and this is the same standard we apply to our troops across the board in the theater. As a member of the Joint Chiefs, I can assure you we do not let our folks go out and operate without the front-line equipment, period.

When I say there is not enough, there is not enough to equip every single individual with every single piece of whatever it is. And I suspect there never will be.

Mr. ENGLAND. If I can comment, Senator, I mean part of what we do is to keep upgrading. We keep adjusting to the threats. So, for example, we started this war we had 700 armored vehicles. We have built 43,000. But now we have another new model which is better.

So if you go to Iraq today there are handfuls of the latest vehicle. Everybody does not have those because obviously it takes some lead time to build them up. And finally we will build all those up. But I expect they will be replaced at some point.

So we have this constant turnover of the "latest" equipment. So at any given point in time, "nobody" has all the latest equipment because it is in manufacture because we are always going to the next, better model.

Admiral GIAMBASTIANI. And these budget submissions that we have made include many of these pieces of equipment and vehicles to upgrade so that we can continue to upgrade and supply our troops.

Senator LAUTENBERG. The Iraqi government sits on billions of dollars that it owns, however it got there. Why should we give any more money to their reconstruction when we have lots of requirements here that are some of them urgent, bridges obsolete and perhaps can collapse.

Why should we be giving those in Iraq more money for reconstruction when the Iraqi government is sitting on a fairly significant reserve?

Mr. ENGLAND. Senator, my understanding is they have somewhere between $12 billion and $15 billion in terms of their own reserves. But they are spending those reserves. They are spending them first to train their own forces and also to equip them and also to develop their oil and electricity and all of that. So there is just a lot of large needs in Iraq. And the dollars we spend there are very important.

Part of this whole effort, as you know, is not just military. It is economic and also political. But there is an economic side of this that is equally very important that we accomplish in conjunction with the military operation.

So we do augment Iraqi funds in this regard. So we do augment those funds, but they also spend their own funds for these—

Senator LAUTENBERG. Has there been any diminution of their—I will call it that treasury or that reserve fund? Those reserve funds that they have?

Mr. ENGLAND. Their budget has been going up each year. I do know that. I am not sure of all of their income, et cetera. But they have, indeed, been spending more. I do not know if their reserves have changed or not, Senator. I will have to get back with you on that.

Senator LAUTENBERG. Admiral, and I will close with this, Mr. Chairman.

I am upset by the lack of knowledge. I mean here we have had this expose in newspapers across the country and television about the disregard for information that the leadership had. And to see these people being put in these humiliating, degrading facilities I think adds insult to injury. Admiral, for a long time now, it has been against the rules to permit photographs of caskets returned, flag covered in every instance, to be widely distributed, disseminated.

Now in front of my office, I am proud to say, that we have easels with lots of the pictures of those who have perished. It is up to date as quickly as we can get the pictures. And it has those who have fallen from every State in the country. And we have a journal that people write comments. They are touching. I read them all of the time.

That picture there brings pride to everybody who sees it. And I cannot, for the life of me, understand why when a coffin is there and it is another one of our bravest, why we cannot permit the photography of that occasion and that flag that says your country loved you and we regret so much that you have paid the price but we honor your sacrifice.

We all have seen it. When Nancy Reagan got the flag from President Ronald Reagan's coffin, she held it like a newborn child. I have seen that with mothers at the burials, wherever they took place, whether it is here or at home.

Can you explain that policy?

Admiral GIAMBASTIANI. I do not know the exact policy but let me just say to you, I do not think there is any issue with ever taking photography at funeral services, presentations of flags.

Senator LAUTENBERG. They cannot stop those, Admiral.

Admiral GIAMBASTIANI. I have seen many of those and I just see nothing.

I think the only restriction that I know of is a restriction when a military aircraft flies in a large number of coffins together, because we bring lots of troops back, dignitaries, other folks, and we put all kinds of cargo on them. Those are the only ones I know of when those coffins are being taken off.

But I will be happy to look into it.

Senator LAUTENBERG. I would appreciate it.

Admiral GIAMBASTIANI. I will just tell you that I grew up, like you, at the Naval Academy during Vietnam looking at pictures of every single one of the fallen and looking at their biographies, which classes they were in. I see this constantly in the military. I look at those tolls personally every single day. And we mourn every single loss of those folks and every single one of the wounded.

But I will look into it. I do not know, Gordon, if you had anything you wanted to add to that.

Mr. ENGLAND. I do not.

Senator LAUTENBERG. Thank you, very much.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator GREGG.

Senator GREGG. I just wanted to pursue this one issue which I am not sure you are in a position to answer. But this question of how you rank the threat and what we should be developing in the military to address as a threat. In your statement, as I mentioned in my opening statement, you pointed to North Korea, Iran and China potentially in different ways as being the priority that we need to worry about.

My reaction was where is al Qaeda and where is the threat of a terrorist attack, a weapon of mass destruction, whether it was a nuclear or a biological weapon.

Physical military response to a terrorist event is maybe not the priority to stopping that event. The priority is to have intelligence on the event's potential occurrence and then being able to interdict the event before it occurs.

And how is the Defense Department approaching that? And are we thinking in those terms? Or are we truly thinking in the terms of nation-state opposition?

Mr. ENGLAND. Senator, if I could just try, first of all, we do try obviously to deter future adversaries, whoever they may be. So we do maintain a core capability, United States military and our Air Force and our Navy and in all of our forces, because it is obviously a lot cheaper to deter in terms of both lives and suffering and the Nation's wealth than it is to fight the war.

So we do invest in deterring, and that is a significant part of our procurement every year, and also of our training.

When it comes to al Qaeda and terrorists, obviously we have a significant cost of literally fighting them every day as part of this global war on terror.

But then here in the United States we do have Northern Command, which we stood up as a new combatant commander, Northern Command, who works hand-in-glove with the Department of Homeland Security. So that is the direct military support combatant commander here in the United States for combating terrorism. So we have an entire combatant commander dedicated to this function here in the United States of America.

And as you know, we obviously invest in our intel assets and our human—that is all a growing part, our Special Forces are all a growing part of our force as part of our global war on terrorism. A lot of that is in our base budget.

The QDR last year, we spent an entire year on this whole subject of making sure we had the right assets, the right sort of training, the right mix of forces. And we made significant changes across the entire United States military and Department of Defense.

So the QDR really outlines the analysis and the strategic approach going forward, including with our coalition partners and friends. Because there is a recognition in this war on terror that no single nation can prevail. This is about friends and allies because a lot of this is taking place obviously in other people's territory. So it does require this constant attention of the world community and that is a large part of the trust we had in our QDR.

So I believe that we have taken a balanced approach and a thoughtful approach in terms of how do we do this in the Department of Defense.

Admiral GIAMBASTIANI. If I could add to what the Deputy has said, your question is a very appropriate one. As Gordon said, we tried to address this in the Quadrennial Defense Review and we have written quite a bit about it.

Operating against nation-states and operating against these terrorist entities is a very different ball game. As you well know, they do not operate by United Nations conventions, Security Council resolutions, the Geneva Convention, or those types of things that nation-states recognize.

For example, just a simple thing, I carry an identification card that says it is a Geneva Convention ID card. None of these folks do. I wear a uniform, and the 2.4 million Americans who are members of the armed forces wear uniforms. These folks do not.

We have designated this as irregular warfare which is why, as the Deputy mentioned, we are increasing, for example, the size of our Special Operations forces. Just in the budgets we have submitted to you there is about 6,000 Special Forces and Special Operations forces that are included in this.

Also, between nation-states there is varying degrees of transparency. We put out public budgets. Other people do not. Al Qaeda does not, for example, and many of these other outfits. So this is a very different world we are moving into, operating with these very shadowy groups that operate across borders, that do not recognize those types of conventions.

Senator GREGG. I appreciate that answer and it is really a topic for a much broader discussion. But I guess my concern is the emphasis and whether we are effectively—I see this threat as being the most present and immediate threat, the use of a weapon to mass destruction on American soil by a terrorist group, which is probably Islamic fundamentalist driven.

Mr. ENGLAND. Senator, we do prioritize in the Department, what we call war plans. Obviously, I cannot go into detail. But I will tell you the No. 1 priority in the Department of Defense is combating terrorism, al Qaeda and other groups like al Qaeda. So that is the No. 1 priority. And we fund those efforts. Those funding requests have priority within the Department of Defense.

We do not deny funding or anything for areas where its focused on the global war in terror. That is our No. 1 funding priority in the Department of Defense.

Senator GREGG. I appreciate all of the time you have given us this morning.

Thank you again for your service.

Chairman CONRAD. Would you like another round?

Senator GREGG. I think I am owed three or four. Put them on account.

[Laughter.]

Chairman CONRAD. First of all, thank you very much for being here. We appreciate it. We appreciate all of your service for the country.

You know, one of the great things about a democracy is we can disagree without, I hope, having to be disagreeable. On a question of disagreement, I hope you will take back this committee is not buying the estimate on the surge. We thought the CBO testimony was very credible. No estimate is going to be exactly right. We understand that. It is especially difficult in a war. We understand that.

Our obligation, I hope you understand, is to try to give the best possible estimate to our colleagues. It is extremely difficult over an extended period. And we are just trying to do a credible job.

I can tell you, whether we are on the defense budget, we are going to provide in the resolution that I present to our colleagues, we are going to provide every dime that is in the President's defense budget. We are going to provide, on the question of funding of the war, we are going to provide actually more funding because we think the President's budget has understated the war cost over the 5-year period.

And we await tomorrow's re-estimate from the Congressional Budget Office before we finalize our budget. That is the last step before we make final determinations.

So with that, again, we thank you for coming and we appreciate your service.

Mr. ENGLAND. Mr. Chairman, thank you for your professionalism. Thank you especially for recognizing this need for the supplemental. Moving that along is hugely important to our men and women in uniform and I appreciate your personal efforts there.

Chairman CONRAD. We will get that job done.

Thank you.

[Whereupon, at 11:54 a.m., the committee was adjourned.]

ANSWERS TO QUESTIONS SUBMITTED

CHARRTS No.: SBC-01-001
Senate Budget Committee
Hearing Date: March 01, 2007
Subject: The President's Defense Budget Request for Fiscal Year 2008 and War Costs
Member: Senator Wyden
Witness: Mr England
Question: #1

Question: Secretary England, the largest single program in the Pentagon budget is Missile Defense. More than $100 billion have already been spent on Missile Defense. Given the very tight budget this year, I have to ask why you are pushing ahead in requesting funding for an additional 25 interceptors and expansion to a third site in Europe when the interceptors you have still haven't proven themselves in realistic testing.

Answer: Concern that nuclear, biological, or chemical weapons are proliferating has heightened the sense of urgency for our country to develop a comprehensive Ballistic Missile Defense System capable of defending the United States, our deployed forces abroad, and our friends and allies against weapons of mass destruction and the ballistic missiles that could deliver them. The threat from ballistic missiles is growing with at least 25 countries now possessing or acquiring sophisticated missile technologies. This became all too evident last July, when our nation's Ballistic Missile Defense System went on alert to counter a very real North Korean threat. We believe it prudent to continue the interceptor program completing additional interceptors for flight tests and for fielding at Ft. Greely and Vandenberg Air Force Base. In order to improve our nation's defenses against an Iranian ballistic missile threat, which intelligence agencies assess Iran could deploy by 2015, we should act swiftly to establish an interceptor field in Europe which could augment our ability to defend the United States against ballistic missiles and simultaneously defend our friends, allies, and deployed forces in Europe from an intermediate and medium range Iranian ballistic missile threat – a defense which does not exist today. Effective defenses take time to build, which is why we must prepare for future threats by acting now. By the beginning of FY08, we plan to have emplaced 24 interceptors into silos, have 20 interceptors in various stages of manufacturing, and be well into manufacturing the long-lead hardware for 10 additional interceptors for the European Site. Our timeline establishes this defense by 2013, just two short years ahead of our current estimate of Iran's timeline. Additionally, it is worth noting that estimating the developmental timeline of closed or fairly closed society is problematic, as demonstrated by how far ahead of the intelligence estimates North Korea developed ballistic missiles and detonated a nuclear weapon.

The MDA Integrated Master Test Plan defines an increasingly realistic flight and ground test program for the Ballistic Missile Defense System program. The progression that we have defined builds upon increasing levels of operationally realistic scenarios, targets, and warfighter interactions. Our BMDS test program includes executing two dedicated and fully integrated GMD flight tests per year, as well as a robust ground test program. The goal of the BMDS test program is to develop scenarios that test the system from end-to-end to the maximum extent possible and to increase our knowledge of, and confidence in, system performance, all while maintaining safety, minimizing artificialities, and keeping pace with the advancing threat. We will continue to add complexity as the test program continues for the GMD element and the overall BMDS.

The recent success of FTG-02 built on the development testing conducted at the Reagan Test range in the South Pacific. FTG-02, launched from an operationally configured silo, versus a developmental silo, demonstrated the integration of operational sensors, interceptor, and a command and control system and was representative of an attack by a single "rogue threat" hostile missile. The DOT&E FY06 Annual Report to Congress stated that "FTG-02 demonstrated end-to-end performance in a flight test using Warfighter operators, an operational midcourse sensor, and an operationally-configured GMD system." Our extensive ground testing program demonstrates the capability of the BMDS against current and future threats, and provides confidence that the system will work as designed when required.

CHARRTS No.: SBC-01-002
Senate Budget Committee
Hearing Date: March 01, 2007
Subject: The President's Defense Budget Request for Fiscal Year 2008 and War Costs
Member: Senator Wyden
Witness: Mr England
Question: #2

Question: Secretary England, the President's proposed budget would create enrollment fees and increases co-pays for some military retirees in the TRICARE program.I know that the Pentagon would rather have military retirees who work use their employer sponsored health care plans instead of TRICARE. However, the sad fact is that many American workers don't have the option because their jobs don't offer health care. This means that dramatically raising the cost of TRICARE may force some retirees out of the health care system entirely. Has the Pentagon estimated how many of those retirees will be left with no health insurance once they have been forced out of TRICARE?

Answer: We do not believe any retirees will be forced out of TRICARE and left with no health insurance. Each retiree, even those without jobs or in jobs that do not have health insurance, still receives retirement income. The proposed increases that we have discussed represent a small portion of retired pay. One of the reasons that last year we proposed a tiered approach is to reflect the fact that junior enlisted retirees do not have the same retirement income as officers. In their case, the increases proposed last year were very modest, with Standard enrollment fees for family coverage of less than $24 a month and the annual deductible increasing only by $70 (from $300 to $370). "Enrollment fees" are equivalent to retiree health care "premiums" in other systems. The most dramatic increases were for retired officers whose retirement income is substantially greater. Their family coverage would require a total enrollment fee of less than $47 a month and the annual deductible increasing by $260 (from $300 to $560).

We have forwarded only general authority for Congress to consider this year. We have emphasized our willingness to work with the Congress on an appropriate set of revisions that will support a sustainable health care benefit for military retirees. We look forward to the interim report, called for by Congress, from the Task Force on the Future of Military Health Care to provide advice on appropriate actions during this session of Congress.

Hearing Date: Mar 01, 2007
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(The information follows):

- The "reserve" should not be viewed as a pot of money that can be used in its entirety for discretionary purposes.

- The amount of accumulated budget funds that had not been spent as of the end of 2006 totaled $9.4 billion; however, the Iraqi Government budget has a planned $7.6 billion deficit in 2007 that would have to be paid for with these funds.

Iraq does not have the option of borrowing to finance the preponderance of its deficit because of limitations imposed by its Standby Agreement with the International Monetary Fund.

- The remaining $1.8 billion is being kept available for possible contingencies such as lower-than-projected oil revenues, which account for almost of the Iraqi Government's income.

CHARRTS No.: SBC-01-003
Senate Budget Committee
Hearing Date: March 01, 2007
Subject: The President's Defense Budget Request for Fiscal Year 2008 and War Costs
Member: Senator Wyden
Witness: Mr. England
Question: #3

Question: Secretary England, the Pentagon has repeatedly told Congress that the Defense Travel System (DTS) would eventually pay for itself by saving money on every transaction. The DTS Program Management Office originally estimated that this would take only 15 years. However that estimate was based on a projected 60-90% utilization rate. The actual utilization rate has only reached 15%.Given this disparity between the actual and the projected utilization rates and the ballooning cost of the program, how long will it take for DTS to break even?

Answer: The DTS was designed and fielded to accommodate temporary duty (TDY) travel for Department of Defense personnel. Other types of travel are not currently processed through DTS, as disparate business processes have not yet been standardized. Considering only TDY transactions, approximately 40% of travel is now executed through DTS, and we are reviewing our travel policies to determine changes that could be made to increase the types of travel that DTS can process. From February 2006 to February 2007, vouchers processed increased by 71%. We anticipate this exponential rate of growth to continue as we emphasize proliferation and training, and increase functionality.

Savings accrue by automating the travel process from end-to-end -- from authorization to reimbursement, and through electronic archiving of travel records. We have engaged the Institute for Defense Analyses to evaluate baseline travel costs to more accurately assess the return on investment of DTS. We expect that analysis to be completed by the end of this fiscal year.